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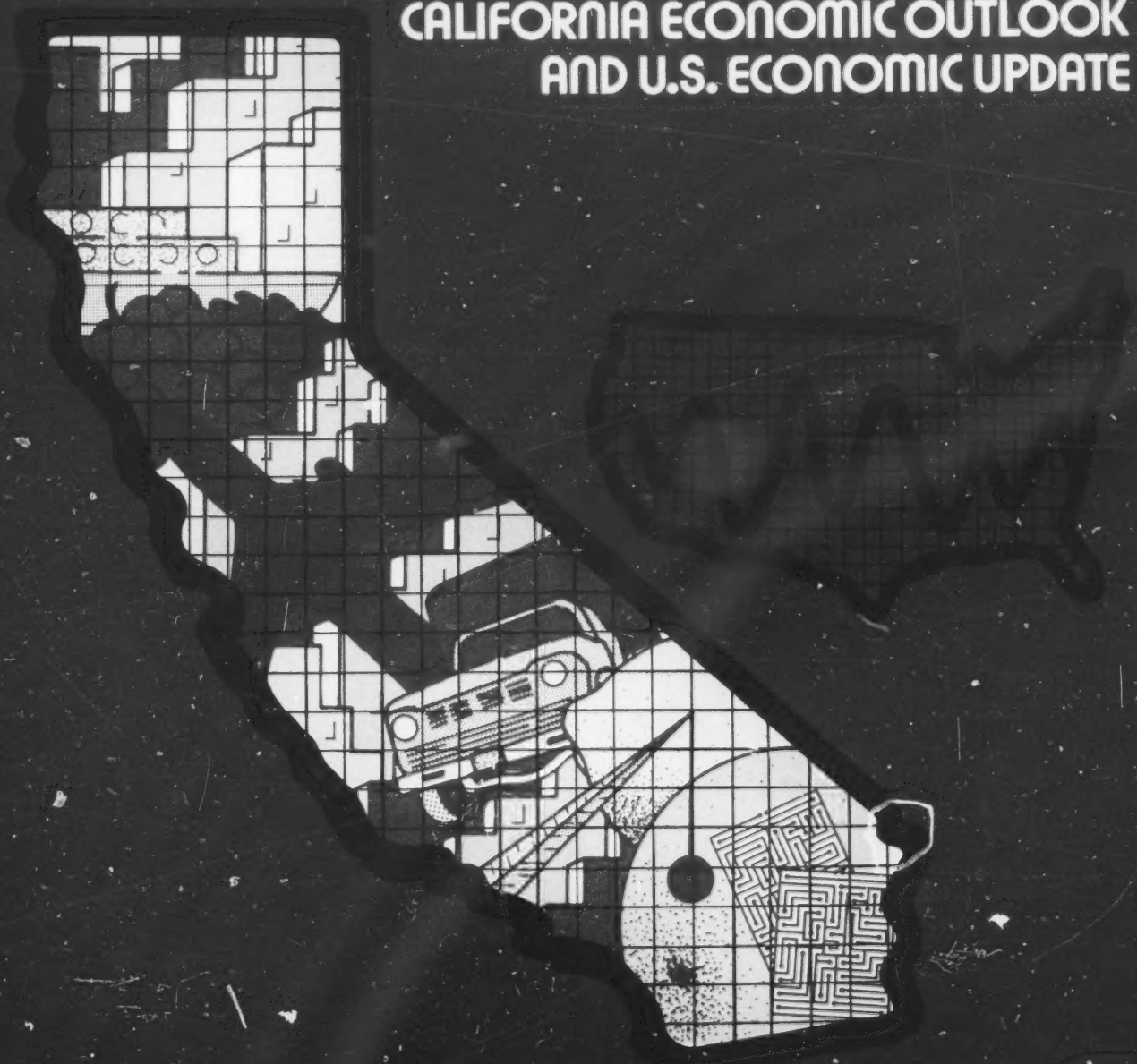
# ECONOMIC REPORT

FALL 1983

## CALIFORNIA ECONOMIC OUTLOOK AND U.S. ECONOMIC UPDATE



SECURITY PACIFIC NATIONAL BANK

# FALL 1983

**Number 70**

**This report highlights the near-term outlook for the California economy through 1984, and includes a near-term update of the U.S. economy.**

**The next issue of the ECONOMIC REPORT will discuss the international outlook. It is scheduled for release in January, 1984.**

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# THE CALIFORNIA NEAR-TERM OUTLOOK

## OVERVIEW

Like the nation, the California economy has experienced several years of very sluggish economic activity. California's real gross state product, a measure of the inflation adjusted value of output for the state's economy, ended the final quarter of 1982 only 1.7 percent above the level achieved during the final quarter of 1979. Indeed, output for all of 1982 actually declined 0.6 percent from the prior year's figure, with the deepest period of contraction occurring in the first quarter of last year when the state's economy fell at a seasonally adjusted annual rate of 6.5 percent.

There are many clear signs that California is rebounding strongly from the most recent recession. Although real gross state product increased less than one percent during the first quarter of 1983, the second and third quarters registered very rapid gains, estimated at 9.3 and 9.8 percent, respectively. For all of 1983, the state's economy is expected to register growth of nearly 3.5 percent, followed by a 1984 expansion of just over 6 percent. Unfortunately, however, the state's economy is likely to begin cooling late in 1984, with the second half of the year expected to show a diminishing growth rate.

The recovery of the California economy has tended to be centered in the consumer and housing sectors. Consumer spending in the state, as measured by taxable sales, is forecast to show a year-over-year gain of more than 6 percent for 1983 and in the neighborhood of 12 percent for 1984. Sales of automobiles and other major consumer durable goods have been doing quite well thus far and are likely to continue to post impressive gains through at least the first several months of 1984. Importantly, consumer price increases will continue at relatively modest rates through 1984 so that the projected dollar volume of taxable sales activity will reflect sizeable expansion in inflation adjusted terms — in the range of 6-7 percent.

**GROSS STATE PRODUCT AND PERSONAL INCOME**
**(Billions of Dollars)**
**Quarterly Detail, 1983-1984**

| | 1983F | | | | 1984F | | | |
|---|---|---|---|---|---|---|---|---|
| | I | II | III | IV | I | II | III | IV |
| Gross State Product | 381.2 | 393.0 | 406.9 | 417.3 | 429.4 | 440.2 | 452.3 | 463.7 |
| 1972 Dollars | 174.2 | 178.1 | 182.3 | 184.6 | 187.5 | 189.7 | 192.3 | 194.2 |
| Personal Income | 319.4 | 326.4 | 335.5 | 344.9 | 355.3 | 364.4 | 373.8 | 382.1 |
| Disposable Personal Income | 271.2 | 278.0 | 287.5 | 295.7 | 305.7 | 313.0 | 320.5 | 327.2 |
| 1972 Dollars | 124.8 | 126.5 | 130.0 | 132.2 | 135.2 | 137.0 | 138.8 | 140.1 |
| Annual Rates of Change: | | | | | | | | |
| Gross State Product | 5.3 | 13.0 | 14.9 | 10.6 | 12.1 | 10.5 | 11.5 | 10.5 |
| 1972 Dollars | 0.7 | 9.3 | 9.8 | 5.1 | 6.4 | 4.8 | 5.6 | 4.0 |
| Personal Income | 2.3 | 8.9 | 11.6 | 11.7 | 12.6 | 10.7 | 10.7 | 9.2 |
| Disposable Personal Income | 3.1 | 10.4 | 14.4 | 11.0 | 14.2 | 9.9 | 9.9 | 8.6 |
| 1972 Dollars | 1.0 | 5.4 | 11.5 | 6.9 | 9.4 | 5.4 | 5.4 | 3.8 |

F = Forecast

California homebuilding activity displayed a remarkable comeback from the very dismal performance of 1982. For all of 1982 only 84,100 residential housing units were authorized for construction, with the bottom of the cycle occurring in February. For that month, residential building permit authorizations fell to only 66,000 units (at an annual rate). By comparison, during June of 1983 permit authorizations surged to 208,400 units. For all of 1983, some 143,500 residential permits are forecast to be authorized, followed by a moderate 1984 increase to 146,600.

California's expanding economy has also meant good news for the state's labor markets. After an increase of only 0.4 percent in total civilian employment during 1982, it is expected that 1983 civilian employment growth will be in the neighborhood of one percent, climbing to almost 4 percent the following year. Based upon that forecast, the average level of civilian employment during 1984 will exceed the 1982 average by more than 500,000 workers. Unlike the figures for total civilian employment, non-agricultural wage and salary employment declined an estimated 1.7 percent during 1982. However, the percentage increases in wage and salary employment anticipated for 1983 and 1984 are essentially the same as those for total civilian employment, and the average level of wage and salary employment for 1984 will also exceed 1982's figure by nearly 500,000. By 1984, the expansion in non-agricultural wage and salary employment is expected to stretch across all major sectors of the state's economy, including construction and both manufacturing and non-manufacturing enterprises. The most significant increases, in percentage terms, will be in the mining, durable goods manufacturing, trade, and services categories.

The improvement in California's labor markets during 1983-84 will promote substantial growth in personal income. Total personal income for the state is expected to show increases of 7 percent and 11 percent for those two years, respectively. Disposable personal income, after adjusting for the effects of inflation, will expand an estimated 4 percent for 1983 and 7 percent for 1984. Based upon the anticipated expansion of the state's population and the forecasted level of total personal income, California's 1984 per capita personal income should be approximately $14,200, some $1,700 above the 1982 figure, and $1,643 above the level projected for the nation as a whole for 1984.

In summary, the California economy has again displayed its ability to rebound strongly from a recessionary environment; indeed, it is also expected that the state's economy will grow at a pace which surpasses that foreseen for the nation as a whole. Unfortunately, like the rest of the nation, California's recovery will be moderated somewhat by continuing high levels of real interest rates. In fact, even the modest increase in interest rates that occurred during the summer of 1983 brought a quick response in such credit-sensitive sectors as housing. With the present recovery materializing during a period of exceptionally high interest rates, it is feared that even the modest interest rate increases that oftentimes occur as the economy gains momentum might have a significant cooling effect on future economic activity.

## EMPLOYMENT TRENDS

California labor market trends have characteristically provided one of the most comprehensive measures of the state's economic vitality, giving a reasonably concise assessment of the state's economic strengths and weaknesses. In particular, developments in the establishment survey of non-agricultural industries' employment totals gives a very good picture-window scan of the sectoral impact of business cycles. Looking first at the broader measures of the state's employment scene, the percentage of persons in the civilian labor force who are unable to find work, it becomes clear that employment opportunities in the state began to contract in the early months of 1980. Following the 1974-75 recession, the state's unemployment rate continued to move downward, reaching its lowest point, 5.9 percent, in January of 1980, and then began a protracted ascent to 11.2 percent in February, 1983. During the period between January 1980 and February 1983 the level of unemployment in California rose from 674 thousand to almost 1.4 million persons, a gain of 103 percent.

California's economic recovery has resulted in substantial progress toward reducing the state's unemployment rate. Indeed, from June to July, 1983, the state's unemployment rate fell a full percentage point, from 10.3 to 9.3 percent. Regrettably, at the time of this writing it is not clear that the dramatic June-July decline was anything more than a statistical aberration resulting from technical influences, such as the seasonal adjustment factor for July over-compensating for the very weak employment growth of the past two years. On the basis of these technical concerns, it is presently assumed that the July reading was an aberration and that

## CALIFORNIA EMPLOYMENT, 1982-1984
**(Thousands)**

| | | | | Annual Growth Rates | | |
|---|---|---|---|---|---|---|
| | 1982A | 1983F | 1984F | 1981-82 | 1982-83 | 1983-84 |
| Civilian Labor Force | 12,189 | 12,300 | 12,608 | 3.2 | 0.9 | 2.5 |
| Total Civilian Employment | 10,978 | 11,098 | 11,511 | 0.4 | 1.1 | 3.7 |
| Unemployment | 1,211 | 1,202 | 1,097 | 38.6 | –0.7 | –8.7 |
| As % of Labor Force | 10.0 | 9.8 | 8.7 | — | — | — |
| Nonagricultural Wage & Salary Workers | 9,827 | 9,965 | 10,314 | –1.7 | 1.4 | 3.5 |
| Mining | 50 | 47 | 49 | 1.9 | –6.0 | 4.3 |
| Construction | 367 | 382 | 396 | –14.3 | 4.1 | 3.7 |
| Manufacturing | 1,929 | 1,925 | 1,988 | –4.7 | –0.2 | 3.3 |
| Nondurable Goods | 623 | 627 | 653 | –3.7 | 0.6 | 4.2 |
| Durable Goods | 1,305 | 1,298 | 1,335 | –5.2 | –0.5 | 2.9 |
| Aerospace | 642 | 649 | 676 | 0.5 | 1.2 | 4.2 |
| Transportation & Public Utilities | 543 | 540 | 550 | –2.2 | –0.6 | 1.9 |
| Trade | 2,276 | 2,331 | 2,443 | –1.1 | 2.4 | 4.8 |
| Finance, Insurance & Real Estate | 645 | 653 | 678 | 0.3 | 1.2 | 3.8 |
| Services | 2,284 | 2,357 | 2,472 | 1.9 | 3.2 | 4.9 |
| Government | 1,733 | 1,730 | 1,738 | –1.3 | –0.2 | 0.5 |
| Federal | 325 | 326 | 331 | –0.9 | 0.3 | 1.5 |
| State & Local | 1,409 | 1,404 | 1,407 | –1.4 | –0.4 | 0.2 |

A = Actual F = Forecast

the state's July unemployment rate was actually higher than reported. For all of 1983 it is presently anticipated that the state's unemployment rate will average 9.8 percent and will average 8.7 percent for 1984. Increasing job opportunities that will result from the economic recovery are expected to generate civilian employment gains of over 500 thousands jobs during the 1983-84 period.

Non-agricultural wage and salary employment trends also showed very disappointing results. Indeed, total nonfarm employment declined for five consecutive quarters, ending in the final quarter of 1982, before displaying consistent signs of expansion during the first half of 1983. The effect of the recession on the major employment sectors was pervasive, with only three major groups — mining; finance, insurance, and real estate; and services recording gains for 1982. The level of nonfarm employment during 1982 shrank from the prior year's by 1.7 percent — a loss of 169 thousand jobs. The years 1983-84 are forecast to show reasonably strong wage and salary employment growth, with all major employment sectors recording gains. In the following sections of this report the outlook for a number of the state's primary-industry groups will be examined at length including: construction, aerospace, agriculture, international trade, banking, and others.

## INCOME AND SPENDING

The growth in California's labor markets during 1983-84 will promote substantial growth in personal income. Total personal income for the state is expected to show increases of 7 percent and 11 percent for those two years, respectively. Disposable personal income, after adjusting for the effects of inflation, will expand an estimated 4 percent for 1983 and 7 percent for 1984. Based upon the anticipated expansion of the state's population and the forecasted level of total personal income, California's 1984 per capita personal income should be approximately $14,200, some $1,700 above the 1982 figure, and $1,643 above the level projected for the nation as a whole.

Total personal income growth will be aided considerably by both the increase in employment as well as the rise in wage rates expected for 1983-84. As a result of those two factors, the wage and salary component of total personal income will record a 1984 average that is some 15 to 18 percent above that for 1982. For 1984, wage and salary disbursements will account for about 61 percent of total personal income, compared with about 62 percent in 1982. One of the principal reasons for the slightly smaller share of total personal income accounted for by wages and salaries will be the substantial increase in both farm and nonfarm proprietors' income — largely the result of the surge in consumer spending and the anticipated strengthening in agricultural prices. Moreover, the contribution of property income to total personal income will likely continue to accelerate as the expanding economy allows property owners to raise rents somewhat more rapidly. In addition to the projected gains in personal income and the effects of the third round of personal tax cuts, consumer optimism will be fueled by reports of declining unemployment and relatively stable prices.

The recovery in the housing market — although blunted somewhat by disappointingly high mortgage interest rates — will provide stimulus for housing related consumer goods such as draperies, household appliances, garden and landscape supplies, etc. Importantly, the 1.1 percent decline of taxable sales recorded for 1982 argues that consumers had postponed many of the discretionary purchases that are likely to be made during 1983 and 1984. The evidence to date suggests that consumers are now more willing to incur debt more readily for such "big ticket" items as automobiles and appliances. As a cautionary note, some industry observers feel that durable goods sales, particularly automobiles, may falter as manufacturers and dealers dismantle interest rate subsidies and price reductions. This fear is especially significant in light of the prospects for some upward pressure on interest rates. It is conceivable that consumers perceived the likelihood of rising interest rates and as a precautionary move accelerated their purchases of high-priced items. While that decision would help account for the sizable surge in consumer spending during the first nine months of 1983, it may also be a harbinger of softening sales in subsequent periods.

**POPULATION AND PERSONAL INCOME**

| | 1982A | 1983F | 1984F |
|---|---|---|---|
| Population (Thousands) | 24,831P | 25,352 | 25,921 |
| Net Migration (Thousands) | 263P | 249 | 271 |
| Personal Income ($ Billions) | 310.3 | 331.6 | 368.9 |
| Per Capita Personal Income ($) | 12,496P | 13,080 | 14,232 |
| Disposable Personal Income ($ Billions) | 262.2 | 283.1 | 316.6 |
| 1972 Dollars | 123.7 | 128.4 | 137.8 |
| Annual Rates of Change: | | | |
| Population | 2.1 | 2.1 | 2.2 |
| Net Migration | -0.4 | -5.3 | 8.8 |
| Personal Income | 7.6 | 6.9 | 11.3 |
| Per Capita Personal Income | 5.3 | 4.7 | 8.8 |
| Disposable Personal Income | 8.4 | 8.0 | 11.8 |
| 1972 Dollars | 2.4 | 3.8 | 7.3 |

A = Actual F = Forecast P = Preliminary

## CONSUMER PRICE TRENDS

California consumer price inflation has trended down sharply for each consecutive year since 1980 when consumer price increases averaged 15.6 percent. During 1982 consumer prices actually declined during the fourth quarter, down by nearly 5 percent at an annual rate, followed by another decline for the first quarter of 1983 of almost one percent. Although consumer prices in California are forecast to begin to rise at an increasing rate through 1984, the state's inflation performance is projected to be better than that for the nation, albeit only marginally. The California Consumer Price Index is foreseen as increasing by just over one percent for 1983 and by 4.6 percent for 1984.

Several of the primary components of consumer prices will be contributing to the overall increase in the index. Food prices, which have already been rising faster than the overall index, will likely be affected further by the harsh and unseasonable weather experienced for much of 1983. In addition, reduced plantings of many commodities, resulting from the PIK program, may result in greater than usual price increases due to reduced harvests. Also, the economic recovery will allow food and beverage retailers (of such products

## GROSS STATE PRODUCT TAXABLE SALES, AND PRICES

| | 1982A | 1983F | 1984F |
|---|---|---|---|
| Gross State Product ($ Billions) | 369.8 | 399.6 | 446.5 |
| 1972 Dollars ($ Billions) | 173.9 | 179.8 | 190.9 |
| Taxable Sales ($ Billions) | 153.4 | 163.1 | 182.8 |
| Consumer Price Index | 294.9 | 298.4 | 312.2 |
| Annual Rates of Change: | | | |
| Gross State Product | 5.3 | 8.3 | 11.7 |
| 1972 Dollars | –0.6 | 3.4 | 6.2 |
| Taxable Sales | –1.0 | 6.3 | 12.1 |
| Consumer Prices | 6.6 | 1.2 | 4.6 |

A = Actual F = Forecast

consumed away from home) to increase prices with less resistance than would have been felt during the recession. Medical care and medical care services are also expected to continue to register price increases that are well above the overall index, in large part reflecting the high cost of introducing new and improved medicine and procedures. Moreover, costs associated with residential fuels and other utilities, and fuels for automobiles, are expected to continue to accelerate, although apparently adequate supplies of natural gas and petroleum products should help to temper those price increases.

On the brighter side, the broad housing component of the Consumer Price Index, as of mid-1983, was actually below the level of mid-1982 for large parts of California. It is probable that the new method of calculating the housing component of the index, which came into effect in 1983, is largely responsible for the decline. Unfortunately, because the methodology is still very new and not well understood in its historical behavior, it is not yet possible to determine accurately what the future influence of the new methodology will be. In its simplest form, the new methodology would treat residential housing as if it were rented on the open market — a rental equivalency concept. Strictly applied, it is likely that the anticipated increase in residential rents would thus soon begin to put upward pressure on the housing component of the California Consumer Price Index. ■

# CALIFORNIA INDUSTRY TRENDS

## AEROSPACE/HIGH TECHNOLOGY

One of the fastest growing and most publicized segments of the economy in recent years has been the high-tech industry. The high-tech industry is actually a combination of many separate industries with certain similar operating characteristics. Though there is no unanimous definition of high tech, two characteristics are generally believed to identify high-tech industries: a relatively high ratio of research and development expense to sales, and approximately 10 percent of the workforce employed in natural science, technical, or engineering occupations. Using this standard, the high-tech industry includes the makers of computers, communications equipment, electronics, aircraft, missiles, office machines, and space vehicles. High-tech industries are extremely competitive and subject to rapid change which can produce tremendous growth or dramatic losses.

Since the beginning of the technological revolution, California has proven to be fertile ground for high-tech industries. Originally drawn to California because of its excellent technical universities and moderate climate, the high-tech industry represents a significant contribution to the state's economy. In terms of wage and salary employment, the high-tech sector provides approximately one third of all manufacturing jobs in the state.

After recording substantial growth rates during the 1970s, California's high-technology industries have experienced slow or stagnant growth during the early 1980s. As evidenced by employment data, high-tech sector jobs increased a meager 0.5 percent in 1982 and are projected to increase only 1.2 percent during 1983. This slowing down of industry growth rates can be greatly attributed to two factors: the U.S. recession and weak export markets. Underlying the sales declines brought on by the recession were high financing costs which decreased profits and demand. Foreign markets were weak for a number of reasons. The strong position of the U.S. dollar makes U.S. goods more expensive overseas, therefore, less attractive. Foreign economies were also experiencing recessions and international competition for high-tech markets has become intense, largely involving Japan and West Germany.

In 1983, the U.S. recession has ended and a modest economic recovery is underway which should bolster sales and profits. The extent of the sales increase depends upon the vigor and sustainability of the economic recovery which could still be sidetracked by historically high interest rates and huge federal government deficits. Even if the overall economy improves, the problem of intense foreign competition will remain. America's early domination in high-tech markets will continue to be challenged thereby guaranteeing continued large expenditures for research and development in order to maintain the U.S.'s technological advantage. The general outlook for California's high-tech industries is for a moderate increase in sales in 1983 followed by stronger increases in 1984 and 1985.

One exception to the poor 1981-82 sales performance rule is the aviation and aerospace sector in general; military aviation and hardware in particular. Because of the Reagan Administration's defense buildup, California's aviation and aerospace industry has been able to weather a severe downturn in commercial airline and general aviation sales. Approximately 22 percent of the total U.S. military budget is channeled into California, a percentage that could rise to 30 percent if the Administration is successful in its attempts to increase defense spending.

Though the fiscal 1984 defense budget is not yet official, spending is expected to show a real increase in the range of 7 to 9 percent. These figures should allow the military aviation and hardware sectors to continue their steady sales increases which began in 1981. The strongest growth associated with the defense buildup is not expected to be felt in California until 1984 and 1985 when major weapons and aircraft systems go into full production. Because of the large federal budget deficit, the projected increases in military spending are coming under increasing attack and could be cut back below the levels proposed by President Reagan. If this should happen, it would be a major disappointment to California's aviation industry.

California has a hand in almost every major military hardware and aviation project. The programs which should provide the major employment opportunities in the years ahead are the B-1 bomber and the Stealth bomber. Another important project which promises to provide jobs for the California aerospace industry is the space shuttle program. The tremendous success of the space shuttle program has opened up the commercial potential of space and could lead to the establishment of a permanent orbiting space station by the end of the century. With more companies desiring a commercial presence in space, the outlook for space related equipment sales is very good.

The commercial airline industry has been buffetted by numerous problems in recent years which led to a combined operating loss of $1 million a day for the last three years for domestic air carriers. The airlines' troubles began when deregulation of routes and fares began in the late 1970s and complicated further by two recessions. As promised, deregulation increased competition and fares dropped to dramatically low levels on some routes as the airlines strived to hold onto their respective market shares. Discount fares have cut revenues drastically even though they have also stimulated increases in passenger traffic. It is estimated that between 70 and 80 percent of all airline passengers are flying on discount fares averaging about 50 percent off of the full fare, resulting in 1982 yields dropping 5 to 6 percent over 1981.

Because of the unprofitable state of U.S. commercial airlines, new aircraft deliveries dropped 16 percent in 1982 and have fallen 30 percent since 1980. Falling profits have not allowed the airlines to replace aging planes as quickly as was done previously. Also, recent declines in the price of fuel has lessened the pressure on the airlines to convert their fleets into new and more efficient planes. It is estimated that for every one cent decline in the price of fuel, the airlines save $100 million. Rising interest expense is another reason for the manufacturing slowdown as the airlines attempt to decrease costs and debt.

The outlook for 1983 for commercial aircraft manufacturers is for no growth over 1982 levels if not a small decrease. Though airline traffic is expected to grow by as much as 9 percent in 1983 because of the economic recovery, the airlines will need a number of consecutive profitable quarters before they will feel in the buying mood. This bodes well for the 1984-85 period since there should be considerable pent-up demand for new aircraft.

Overall, the high-tech sector is projected to increase payrolls by 4.2 percent in 1984, or approximately 27 thousand new jobs over 1983. The recovery will continue to be led by military aviation and hardware, while commercial aviation will begin to turn itself around. Electronic components, measuring and controlling devices, communications equipment, and radio and TV receiving equipment should also be fast growing areas in 1984.

## BANKING

The tight-credit environment that prevailed during the past two years contributed greatly to the broad weakness of the California economy and also had a significant impact on the state's commercial banking industry. The high cost of funds to financial institutions, whether acquired through deposits or purchased, caused the industry to maintain lending rates far above levels that had earlier been anticipated. As a result, consumer and real estate borrowing were both very weak during 1982. On the other hand, the debt and equity markets offered relatively unattractive alternative sources for long-term capital to commercial and industrial firms for much of 1982, prompting many firms to rely on traditional commercial lenders for short-term financing. Gross loans generated in the commercial banking sector increased just under 10 percent for 1982, but most of that increase was in commercial and industrial lending — more than 40 percent of the total.

A sharp reversal of 1982 trends occurred in the California commercial banking industry during 1983 as the economic recovery was paralleled by a surge in consumer and real estate lending. The comparatively lower level of interest rates that prevailed during the first half of 1983 triggered a broad rebound in housing and major consumer durable goods sales, directly affecting the balance sheet of the commercial banking industry. Although there is some concern that the final months of 1983 will see interest rates on a slightly upward path, it is not presently apparent that there will be sufficient upward movement to curtail substantially the growth in consumer and real estate lending.

Commercial and industrial loan demand, on the other hand, showed a relatively anemic performance during the first half of 1983, and that trend is likely to continue through early 1984. With stock prices well above the levels of recent years and with the equity market

## CALIFORNIA BANKING FORECAST
**(Outstandings, End of Year)**

| | | | | Annual Growth Rates | | |
|---|---|---|---|---|---|---|
| | 1982P | 1983F | 1984F | 1981-82 | 1982-83 | 1983-84 |
| Gross Loans* ($ Billions) | 141.6 | 154.1 | 165.4 | 9.9 | 8.8 | 7.3 |
| Commercial & Industrial | 46.3 | 51.6 | 54.2 | 17.2 | 11.5 | 5.0 |
| Real Estate | 53.7 | 57.1 | 61.7 | 2.7 | 6.3 | 8.1 |
| Consumer | 22.0 | 22.9 | 24.1 | N.C. | 4.1 | 5.4 |
| All Other | 19.6 | 22.5 | 25.4 | 29.8 | 14.9 | 12.6 |
| Total Deposits ($ Billions) | 165.1 | 182.1 | 195.0 | 8.4 | 10.3 | 7.1 |
| Demand | 40.4 | 35.2 | 32.7 | –5.4 | –12.9 | –7.1 |
| Time & Savings | 124.7 | 146.9 | 162.3 | 13.8 | 17.8 | 10.5 |
| Loan-To-Deposit Ratio (%) | 85.8 | 84.6 | 84.8 | | | |

*Minus loans to domestic commercial banks
P = Preliminary F = Forecast N.C. = No Change

offering more competitively priced long-term capital, commercial and industrial bank loans are likely to diminish in importance to business and its growth rate should fall from 17.2 percent in 1982 to 9.2 percent in 1984. Even though the growth in commercial and industrial loans is projected to slow in both 1983 and 1984 as a proportion of gross commercial bank loans, that category will increase from 33 percent in 1982 to 35 percent in 1984.

On the liability side of the commercial banking balance sheet, a significant trend toward new deposit instruments continues to redistribute the flow of deposits in favor of time and saving accounts. Prompted by the need to compete with money market funds, the banking industry was successful in its bid to gain a new type of account that offered interest rate flexibility, liquidity and limited transactions ability. After the authorization of such accounts by the Depository Institutions Deregulation Committee last year, the commercial banking industry began immediately to repatriate deposits that had been lost to money market mutual funds and others. The new accounts are generally of two forms. The first, introduced December 14, 1982, is offered free of interest rate ceilings as long as a minimum balance of $2,500 is maintained; it also provides for a limited number of withdrawals. The second type of new account, "Super NOW," is very similar to the Money Market Deposit Account discussed above. The Super NOWs, which became available January 5, 1983, provide for an unlimited number of transfers and are available only to individuals, governmental units, and non-profit corporations. Both types of accounts offer the security of the Federal Deposit Insurance Corporation.

The growth in commercial bank deposits that resulted from the introduction of these new accounts would likely have been even greater had it not been for the offsetting influence of the stock market's recovery. Moreover, the rebound in consumer spending associated with the economic recovery also sidetracked a portion of household wealth and personal income growth into consumption rather than saving. That view is supported by the low saving rate experienced during the second, and perhaps third, quarters of 1983. Nonetheless, time and saving deposits are forecast to finish 1984 some 30 percent above the level recorded at the end of 1982, and demand deposits are forecast to decline 19 percent during that same time span.

## CONSTRUCTION OUTLOOK

As has been the case to date, California's residential and nonresidential building sectors are likely to exhibit somewhat different trends through 1983. The pace of homebuilding in the state more than doubled between June 1982 and June 1983. June 1983 activity is not seen as sustainable, but total housing unit authorizations are

projected at 70 percent above the depressed 1982 figure, with a small additional gain in homebuilding anticipated in 1984. More modest real growth over the next 18 months is forecast for the state's nonresidential building, a sector that held up well during the 1981-82 recession but is currently suffering from excess inventory in some markets.

After dropping to the lowest pace of the post-World War II period, California housing permit activity began to recover in the fourth quarter of 1982. And during the first six months of this year, the number of housing units authorized statewide was up 112 percent from the level for the January-June 1982 period.

The pick up in the state's residential building permit activity coincided with declines in both mortgage and short-term interest rates. For example, California's effective fixed mortgage rate on conventionally-financed single-family dwellings averaged about 12.6 percent in early July — down from nearly 15 percent in September, 1982. Similarly, the prime rate — one determinant of construction loan rates — fell from 16.5 percent early last summer to around 10.5 to 11.0 percent during the summer of 1983.

Though the overall rise in the state's housing permit activity since last fall is significant, the seasonally-adjusted figures also show considerable month-to-month fluctuation. Another trend characterizing California's homebuilding recovery is the greater strength of the single-family dwelling sector. Figures for the first six months of this year show that permit authorizations for single-family homes increased 127 percent over the corresponding 1982 period. That increase compares with a 90 percent gain in multifamily unit authorizations and an increase in home building remodeling activity estimated at 15 percent.

Clearly, California homebuilding activity displayed a remarkable comeback from the very dismal performance of 1982. For all of 1982 only 84,100 residential housing units were authorized for construction, with the bottom of the cycle occurring in February. For that month, residential building permit authorizations fell to only 66,00 units (at an annual rate). By comparison, during June of 1983, permit authorizations surged to 208,400 units. There were two very important features of the phenomenal rebound in housing recorded during the second quarter of 1983 that must be considered in an assessment of the outlook for construction activity through 1984. First, both builders and buyers perceived correctly that mortgage interest rates were likely to remain at relatively low levels for only a short period of time. As a result, both were eager to take advantage of the "interest-rate window." Second, June's total housing unit authorizations were affected significantly by the implementation of new state energy regulations.

After a year's postponement and some revision, the state's new Residential Energy Conservation Standards became effective June 15. Many builders, in anticipation of the new standards, took out building permits before the mid-June implementation date. As a result, the number of building permits issued for June — and perhaps even previous months — was substantially higher than would otherwise have been the case. Thus, it is likely that subsequent months' building permit activity will be reduced because of the June surge. Moreover, it should be noted that many of the permits issued in June may be cancelled later in the year. Nonetheless, for all of 1983, some 143,500 residential permits are forecast to be authorized, followed by a moderate 1984 increase to 146,600.

On the positive side, inventories of existing new homes are being brought into line with the apparent current demand for new homes. In addition, fixed-rate conventional mortgages in the 12 to 14 percent range are likely to prevail for the next several quarters; a period in which home price appreciation rates are likely to be moderate. Of major significance is the coincidence of an improving affordability picture coupled with an outlook for a resumption of growth in Californians' personal income. While not nearly enough of the disparity has been eliminated between the cost of purchasing a home and consumers' ability to meet the mortgage payment requirements, a catchup period seems to be at hand. Nonetheless, builders would do well to remember the lessons of the past few years when planning 1983 and 1984 production levels.

In contrast to California's residential building activity, the state's nonresidential construction held up well during the 1981-82 recession, as a surge in office building activity largely offset declines in industrial construction. But with vacancy rates now at high levels, office construction has experienced weakness during the first half of 1983. Overall, nonresidential permit activity experienced a real decline of about 5 percent between the first six months of 1982 and the same period of 1983. During this interval, inflation-adjusted permit valuations for commercial and industrial building declined an estimated 10 percent, but that reduction was partially offset by increased nonresidential alterations and additions activity.

Undoubtedly, the 1983 weakness in California's commercial building sector was largely the result of a growing amount of office space available. Vacancy rates in the state's major office markets increased during 1982. Mid-1983 figures from Coldwell Banker show a 7.2 percent office vacancy rate in downtown San Francisco, 13.0 in Los Angeles, and 23.3 percent in San Diego. Corresponding figures for 1982 were 3.4 percent for San Francisco, 3.8 percent for Los Angeles, and 19.8 percent for San Diego.

The 1983 decline in industrial building continues a trend that has prevailed since 1980, and reflects low rates of manufacturing capacity utilization. Given the excess nonresidential capacity, it is not surprising that only modest growth for this sector is expected over the next 18 months. Commercial permit valuations are expected to increase 1.1 percent in 1983 and 10.8 percent in 1984. The modest advance in commercial construction activity will do little to offset the continued weakness in the industrial building sector during 1983; the total valuation of nonresidential construction is projected at almost $9.0 billion for the year.

As the economic recovery in California continues in the months ahead, the outlook for virtually all categories of nonresidential construction should improve. The strongest performer by 1984, however, will be new industrial construction. By that time the concurrent factors of economic recovery and the projected gains from the planned increase in defense spending should be generating a substantial influence on the state's industrial building sector.

Of course, it should be noted that industrial building permit authorizations — even for 1984 — will reach a dollar volume that is only about one-fourth or less the size of new commercial buildings. Moreover, alterations and additions to existing nonresidential structures will account for a major proportion of the funds spent on nonresidential construction, especially during 1983, resulting in expenditures for alterations and additions that are more than double those for new industrial buildings.

## CALIFORNIA CONSTRUCTION FORECAST

| | | | | Annual Growth Rates | | |
|---|---|---|---|---|---|---|
| | 1982A | 1983F | 1984F | 1981-82 | 1982-83 | 1983-84 |
| New Housing Permits (000) | 84.2 | 143.5 | 146.6 | -19.7 | 70.4 | 2.3 |
| Single Units | 49.8 | 86.1 | 85.0 | -17.0 | 72.9 | -1.3 |
| Multiple Units | 34.4 | 57.4 | 61.6 | -23.4 | 66.9 | 7.3 |
| Total Valuation ($ Millions) | 14,882 | 19,223 | 20,467 | -9.4 | 29.2 | 6.5 |
| Residential | 6,169 | 10,330 | 10,812 | -18.0 | 67.5 | 4.7 |
| Single Units | 3,444 | 6,143 | 6,356 | -16.6 | 78.4 | 3.5 |
| Multiple Units | 1,484 | 2,788 | 2,948 | -31.1 | 87.8 | 5.7 |
| Alterations | 1,241 | 1,399 | 1,508 | 0.5 | 12.7 | 7.8 |
| Nonresidential* | 8,713 | 8,893 | 9,655 | -2.2 | 2.1 | 8.6 |
| Commercial | 4,168 | 4,214 | 4,669 | 3.3 | 1.1 | 10.8 |
| Industrial | 1,047 | 915 | 1,010 | -29.5 | -12.6 | 10.4 |
| Alterations | 2,098 | 2,478 | 2,627 | 0.9 | 18.1 | 6.0 |
| Other | 1,340 | 1,286 | 1,349 | 7.0 | -4.0 | 4.9 |

A = Actual F = Forecast

*Note: Beginning with data for 1980, permits for nonresidential alterations and additions valued at $100,000 and over are no longer classified as new construction, resulting in lower totals for commercial, industrial, and other construction and higher totals for nonresidential alterations/additions. Consequently, only total nonresidential valuations are strictly comparable with past data.

## INTERNATIONAL TRADE*

### Overview

The world-wide recession of 1981-82 put the brakes on the economic and international trade expansion experienced by California and its leading trading partners during the decade of the 70s. The double digit real economic growth rates posted in the past decade by countries such as Japan, Taiwan, and South Korea will probably seldom be achieved again. The average annual growth rate of 10.5 percent in real terms for the state's international trade during the 1970 to 1980 period was largely based on those countries' continued economic growth as well as the state's. Indeed, during much of the decade, California's economy outperformed the nation's.

In 1982, California's international trade increased less-than one percent annually, reflecting the worldwide recessionary conditions. Exports decreased 3 percent, to $29.1 billion, while imports increased 3 percent to $32.6 billion. As a result, the state's trade deficit widened to $3.5 billion.

It is not at all unusual for California to post a substantial trade deficit, and the relative size of that deficit tends to run in cycles. In 1981, the state almost achieved a balance — running a deficit of slightly over $15 billion. Nineteen-eighty-two marked the beginning of another cycle of escalating deficits, and in 1983 the deficit could easily reach $5 billion.

Two major factors are likely to help the state's imports continue to increase at a faster rate than its exports. The first is the expected rates of recovery of California's economy compared to that of its major trading partners. The second is the continued high value of the U.S. dollar vis-a-vis its major trading partners' currencies. California's economic recovery will spur demand for many imported consumer goods as well as some capital products. The expected increase in the volume of imports will be helped by the high value of the dollar which makes imported goods cheaper on domestic markets. The very same factors that are encouraging import growth during 1983 will discourage export growth during the year. The slower recovery of buying countries' ecnomies will preclude their stepping up purchases of California products, while the high value of the dollar will make those products more expensive on foreign markets and thus, further curtailing demand. The consequences of those trends are apparent in the results of the first five months of trading. During that period, imports increased 5.5 percent to total $14.1 billion while exports decreased 2.2 percent to reach $12.2 billion.

The state of California includes three customs districts: Los Angeles, San Francisco, and San Diego. Together the districts accounted for 14 percent of the total international trade in the U.S. and 64 percent of total West Coast trade in 1982. Nationally, Los Angeles ranked in second place, behind New York, in terms of international trade value, and San Francisco ranked sixth. Historically, Northern California's trade picture has differed somewhat from the Southland's because of its proximity to the source of the state's principal exports: agricultural commodities and electronic products. Southern California is the unloading area for some of California's major imports such as petroleum and cars.

**CALIFORNIA'S LEADING TRADING PARTNERS**
**January - May, 1983**
**($ Millions)**

| Country | Imports | Exports | Total Trade |
|---|---|---|---|
| Japan | 5,626 | 2,840 | 8,466 |
| South Korea | 906 | 1,106 | 2,012 |
| Taiwan | 1,327 | 601 | 1,928 |
| Singapore | 382 | 931 | 1,312 |
| Hong Kong | 687 | 526 | 1,213 |
| West Germany | 605 | 394 | 999 |
| Australia | 162 | 773 | 934 |
| United Kingdom | 346 | 579 | 925 |
| Mexico | 415 | 476 | 891 |
| Malaysia | 388 | 464 | 852 |

Source: U.S. Department of Commerce; Security Pacific Bank's International Trade Databank.

*It is important to note that the value of the goods exported and imported cannot be totally ascribed to California's economy, as the U.S. government records only the movements of commodities through the various ports and airports, not the points of origin or ultimate destinations. Thus, when "California's imports, exports, and trade balance" are mentioned, it should be borne in mind that the goods in question may not have been manufactured in the state or may ultimately end up in a state or country other than the original point of destination.

## Imports

Of the five major import categories, office machines registered the highest yearly rate of increase — 74 percent — during the first five months of 1983. Copying and data processing machines and their parts are the components of the category. Of those, data processing machines registered a 124 percent increase to reach $210 million while the value of imported parts rose 93 percent to total $573 million. Electronic components was another major import category which registered a healthy increase — 23 percent — during the first part of the year. Integrated circuits valued at $1 billion were the major component of the category. Wearing apparel started to recover from its poor performance in previous years by posting a 12 percent increase. Two major import categories posted year-over-year decreases: cars and petroleum.

**CALIFORNIA'S LEADING IMPORTS**
**January-May, 1983**

| | $ Millions | 1983-82 % Change |
|---|---|---|
| 1. Cars | 1,446 | −11 |
| 2. Electronic Components | 1.208 | +23 |
| 3. Office Machines | 887 | +74 |
| 4. Wearing Apparel | 648 | +12 |
| 5. Crude Petroleum | 570 | −12 |

Sources: U.S. Department of Commerce; Security Pacific Bank's International Trade Databank.

## Exports

During the first five months of 1983, exports of aircraft and parts and data processing and office machines performed quite well. Aircraft showed the most impressive increase, 63 percent; while parts increased 6 percent. The aircraft market is particularly sensitive to economic dowturns. In 1982, for example, exports of aircraft were down 37 percent. Thus, it is important to note that 1983's increase is based on year-earlier depressed levels. Office machines exports accounted for $598 million of the data processing and office machines category, a 33 percent annual increase. Data processing machines exports increased 23 percent.

Agricultural products, led by cotton, are bearing the brunt of the state's export slowdown. In 1982, agricultural exports decreased 15 percent from their 1981 total of $5.9 billion. During the first five months of 1983, agricultural exports dropped a further 15 percent to total $1.9 billion. Cotton exports, the state's leading agricultural export, fell 29 percent, while grains dropped 15 percent, and fruits and nuts decreased 4 percent.

**CALIFORNIA'S LEADING EXPORTS**
**January-May, 1983**

| | $ Millions | 1983-82 % Change |
|---|---|---|
| 1. Aircraft & Parts | 1,234 | +29 |
| 2. Electronic Components | 1,186 | + 4 |
| 3. Automatic Data Processing & Office Machines | 1,225 | +27 |
| 4. Cotton | 582 | −29 |
| 5. Boilers, Nonelectric Motors & Engines | 566 | −16 |

Sources: U.S. Department of Commerce; Security Pacific Bank's International Trade Databank.

## CALIFORNIA AGRICULTURE

The California agricultural industry has been plagued by depressed market prices and weather problems. Overabundant production and the 1981-82 recession have caused commodity prices to fall. Fortunately, high yields, lower production costs, and the agricultural industry's diversification have precluded a more serious downturn.

Despite generally lower market prices, total cash receipts paid to California ranchers and farmers increased by 2 percent in 1982 amounting to approximately $14.3 billion. In some cases, greater volumes of production tended to offset lower prices. Much of the fruit, nut, and vegetable categories increased their cash receipt totals while most field crops declined. This was the 35th consecutive year of increasing cash receipts for California agriculture. The state continues to lead the nation in agricultural production.

Unfortunately, net income has not kept up with cash receipts. It is expected that net income for 1982 will be

unchanged from 1981 which was the third consecutive year of sharply declining net income. The upward trend of production costs has slowed because of a reduction in interest rates and energy prices. Relative to the high cost of financing, growers experienced lower production costs in the latter half of 1982. Reduced energy prices have contributed to smaller price increases for fuel, fertilizers, and other agricultural chemicals. Irrigation pumping costs have been moderated by both lower energy prices and the abundance of water supplies as a result of heavy precipitation.

The foreign market for California's agricultural products has also been extremely soft. The value at port of exportation for California's agricultural products was only $3.3 billion in 1982, down 21 percent. In addition to the slow growth of world economies, the high value of the U.S. dollar has been a major factor in the decline of California's ag exports. The strong dollar has made our agricultural products much more expensive for foreign buyers. Crop production increases by other countries in rice and cotton have also weakened the demand for California's commodities.

In 1983, total cash receipts for California agriculture may decline since extreme weather has reduced production. The very wet winter flooded fields, killed trees, and ruined some harvests. The rainy weather seriously delayed the planting of some crops. Additionally, the mild winter temperatures in combination with the heavy precipitation contributed to a more serious than usual pest problem. The weather patterns in California this year were not only unusual but varied sharply from week to week and region to region.

In addition to weather difficulties, approximately 1.5 million acres were removed from production in 1983 as a result of the government's Payment-In-Kind (PIK) program. This figure represents about one third of the base acreage recorded with the government's price support programs.

Briefly, the PIK program was established by the U.S. Department of Agriculture as a means of reducing commodity surpluses and avoiding greater expenditures on price support programs. PIK provides eligible growers an opportunity to receive title to government-owned commodities in exchange for setting aside acreage from production. Previous to 1983, government support programs have not been important to California agriculture because of a $50,000 ceiling on payments to any single grower. Most producers in California are sufficiently large enough that $50,000 would make government programs less attractive than producing. But the ceiling on payments was lifted and along with the expected bad weather, many growers decided to participate in the PIK program — many more than the government had anticipated.

While gross income may decline, net income in 1983 should rise slightly. Production costs are not expected to increase this year, interest rates and the resulting cost of financing are expected to be stable, and the PIK payments will offset the probable decline in cash receipts.

As a result of the acreage set aside, there will be an immediate boost to net income for the producer. However, many allied industries are suffering as a consequence of the reduced production. Agricultural equipment dealers and manufacturers, chemical distributors and manufacturers, seed companies, and cotton ginners have all been impacted by the reduced production. Additionally, higher feed prices resulting from the set aside acreage and weather problems have hurt livestock producers.

In reality, the California agricultural industry is a multitude of industries comprising many diverse operations. A producer's profitability need not follow the trend of aggregate statistics, rather his profitability depends upon efficient operation, the amount of debt, and luck with "Mother Nature."

Yet, California is challenged by its own capacity to produce. Agricultural producers are faced with surplus production and markets that are not growing as fast as anticipated. Exports of California's agricultural products have been slowed because of the U.S. dollar's strength and protectionism threatens to slow world trade even more. Government support has provided short-term relief to the problems of weak market prices, but it is unlikely that such levels of support can be sustained indefinitely.

While less competitive production may need to be reduced and market expansion efforts made, most ag producers in California feel that they have a competitive edge over producers in other states and other parts of the world. California enjoys rich soil with sufficient irrigation, and weather which generally allows year-round production. California produces more than 250 different crops or livestock products. While the demand for agricultural products is increasing throughout the world, good farmland is becoming scarce. California's proximity to the Pacific Rim countries, the area of greatest market growth potential, is a major factor in the positive outlook for California ag in the coming decades.

## TRAVEL AND TOURISM — RECENT TRENDS AND OUTLOOK

With less than 12 months until the long anticipated Olympic visitors begin to arrive, California's travel-related businesses are looking forward to a brighter future, happy to put the past few recession-battered years behind them. In 1982, according to the state Office of Tourism, trips by domestic travelers in the state dipped 7.4 percent from the year before. And, foreign travel was off even more, with data for the last six months of 1982 showing an annual decline of 18.9 percent at Los Angeles International Airport and alien arrivals at San Francisco International off 10.4 percent — a combined drop of 16.8 percent. Those declines reflect a wide variety of complex worldwide problems and are particularly distressing to California's economy since the travel industry is broad-based and has a wide ranging influence throughout the state. From a national perspective, California is the leading state in travel revenues (over $27 billion) and travel-related jobs, is a top site for conventions, and has many of the country's leading attractions. In addition, significant tax revenues are generated at both the state and local levels. This article reviews some recent economic trends, issues, and the outlook for the travel and tourism industry.

Hotels and motels represent one of the leading components of the travel industry, accounting for about 13 percent of domestic traveler spending in the state. In terms of 1982 hotel revenues, Los Angeles, San Diego, and San Francisco were among the nation's top ten counties, with a combined total estimated at $1.1 billion — about 7 percent of the U.S. total.

In general, the hotel industry was hit by a decline in business travel, lower convention attendance, and cautious vacation spending during 1982. Occupancy rates, a key measurement in the industry, were below year ago levels in both Northern and Southern California. For example, in the Los Angeles-Orange County area, the 1982 occupancy level of 68.7 percent was 8.1 percent below 1981, according to a report by the CPA firm of Pannell Kerr Forster. That decline was widespread, with only Los Angeles County's South Bay area bettering 1981's occupancy rates, and Orange County and the Los Angeles airport areas, with modest declines of less than 3 percent, outperforming other areas measured. In Northern California average occupany was 69.7 percent, a decline of 5.1 percent from 1981. The highest occupancy rate among the Northern California areas surveyed was in Santa Clara County with 76.2 percent, a drop of 1.3 percent from the previous year. Increases in occupancy rates were achieved by San Mateo County (up 2.7 percent), Sacramento (1.7 percent), and the North Coast counties (0.7 percent). Room rate increases, up 7.4 percent on average in the Los Angeles area and 7 percent in Northern California, kept revenues from falling in the face of the occupancy declines, but the room rate increases were significantly lower than in 1981, reflecting softness in demand and lower inflation.

San Diego, with a 1982 hotel occupancy rate of 74.5 percent (4.1 percent below 1981), registered higher occupancy than Los Angeles or Northern California, while room rates increased 9.4 percent according to a report from that county's Convention & Visitors' Bureau. San Diego's higher room rate increases are related to the fact that historically prices have been lower than those in similar resort areas. San Diego had the lowest 1982 average daily room rate of the three areas at $57.50, followed by Northern California ($57.91), and Los Angeles - Orange County at $59.29. The less expensive facilities in San Diego County posted higher occupancy than ever before, a trend seen in many areas of the state, reflecting cautious consumer spending.

Hotel and motel employment represents about 5 percent of all service jobs in California. In 1982, 117,400 of the state's residents were employed in this industry, 2,200 people less than the previous year — a decline that is uncharacteristic of a business that registered increased employment every year in the past decade except 1974.

Despite a difficult year, construction of hotels and motels continued unabated, with 1982 building permit valuations increasing an impressive 204.8 percent in the state. Many of the new hotel permits authorized construction in Southern California, some of which was in anticipation of the 1984 Olympic Games. Of the $662.9 million in permits issued, almost 70 percent was in the 9-county Southern California region. Hotel/motel projects represented over 11 percent of all major nonresidential building in the state last year.

### Foreign Travel Weakened by Recession and Strong U.S. Dollar

Travel by foreign visitors was down last year in California for some conspicuous economic reasons. The strength of the U.S. dollar has made California less of a bargain for foreign travelers from many countries. And worldwide economic problems severely impacted

discretionary spending decisions. Visitor declines were certainly not unique to California. Travel by foreigners to the U.S. dropped 9 percent in 1982 — the first downturn in inbound traffic in two decades. Comparable annual figures are not available for California, but partial data and estimates by the state Office of Tourism suggest a significant decline extending into 1983. The Mexican tourist has been particularly important to the state and the peso devaluations have limited border traffic, air passenger arrivals, and attraction attendance. Travel to the U.S. by Europeans and Canadians continues to be affected adversely by a strong U.S. currency. But the number of Japanese visitors in the state has probably remained steady, with growth held back by the less expensive choices of nearer destinations such as Hawaii.

In general, 1983 tourism revenues should show improvement over 1982 but those gains may be slow and modest, and competition will be strong for travel dollars. California has some new draws; for example, the Spruce Goose opened in Long Beach in May, and major new attractions have been unveiled at Disneyland, Knotts Berry Farm, Sea World, and Magic Mountain. Also, the opening of the Moscone Convention Center in San Francisco is helping to increase travel spending in the Bay Area. The year 1984, of course, will not be typical since tourism spending will be uniquely influenced by the Olympic Games in Southern California and the Democratic National Nominating Convention in San Francisco. Both events are expected to benefit wide areas of the state.

Change plays a vital role in the travel industry and California has usually responded well to that challenge. But competition is likely to intensify in many industries through the 1980s, with increased competitiveness already evident in tourism. For example, new alternatives in the airline industry have recently proliferated such as airlines specializing in bargain fares, while the accommodation sector has seen the growth of bed and breakfast facilities and "all-suite" hotels offering a wide array of services at an attractive price. Travel agents also face the possibility of increased competition as a result of a Civil Aeronautics Board ruling last December which may permit airlines to appoint other companies to handle tickets — now about 70 percent of all airline tickets are issued by travel agencies. Last year's bus deregulation will promote new competition for sightseeing and tour package businesses in the state.

In the cruise ship industry, competition surged as greater consumer demand resulted in a substantial increase in capacity starting in about 1979. Capacity will likely grow 40 percent between 1982 and 1984. With more companies vying for the cruise passsenger dollar, price discounting, which may continue until demand matches available capacity, has become common on many lines.

California as a destination will face increased competition for the travel dollar from other areas of the U.S. and from foreign countries. One of the increasingly important keys to meeting the competition of the 1980s will be the ability of the travel industry to understand and meet consumer needs. Demographics suggest that the dominant consumers of the decade will be the baby boom generation. It is likely that the values and lifestyles of this well educated and older group may require some fundamental changes in many industries, and travel will be particularly sensitive to any changes which affect discretionary buying decisions.

Consumer caution, evident during the recent economic downturn, may be a longer term trend carrying well past the recession. More accustomed now to weighing spending decisions, with less willingness to engage in impulsive buying choices, consumers are expected to be more selective and demand a high quality of travel service for the dollar spent. Consumer planning is expected to play a greater role in travel spending, and, while lower overall expenditures are not likely, the consumer will require more information on which to base decisions.

As in many retail businesses, there may be some erosion of the traditional middle market — making market research increasingly important. (This is particularly critical in the planning of future facilities and equipment since many segments of this industry are capital intensive and have a large investment in fixed assets.) In general, demand for recreation and travel will continue to be strong, but consumer selectivity and changing values are likely to play a more prominent role in travel industry planning at least over the next few years.

Recovery from recent economic problems will not necessarily be synonymous with a return to the pattern of past growth, but overall the view for the future of California's travel industry is optimistic given its many natural attractions and excellent facilities. Notwithstanding the state's undeniable attractiveness to visitors, one area where California falls short is in funding for state tourism promotion. The state Office of

Tourism budget, at about $580,000, ranks below almost all other states. Many of California's competitors spend far more in attracting visitors — Florida's budget is about $9 million, Arizona's is over $1.6 million and New York's is $12 million.

Travel and tourism are an important source of government revenues; for example, in 1981 state tax revenues from tourism-related spending totaled some $927.3 million. And, for every tax dollar spent on tourism promotion, development, or research by the state Office of Tourism, close to $1,700 were returned in taxes. There is a generally accepted need within the industry for a central organization to provide these services for the state to stay competitive. And while increased spending in California is unlikely given current fiscal realities, a proposal has been made by the governor to form a privately funded tourism corporation.

## A Special Note on the Olympics

With less than a year to go until Southern California is host to the 1984 summer Olympic Games, the area is starting to benefit from next year's big event. Much of the planning and construction is either well underway or completed and some associated events have already been held. The Olympic Games are expected to add over $3 billion to Southern California's economy and create about 68,000 temporary jobs. Olympic related spending should impact a large segment of the region's economy, and, since events will be spread over a five-county area, many communities will have an opportunity to benefit. Some 625,000 out-of-town visitors are expected with spending projected to reach over $332 million for this group alone. Personal expenditures by local residents of $30.7 million are also forecast. Long term benefits to the area also should be substantial. The active role of the business community in next year's Olympics makes our games unique — perhaps this approach and spirit of cooperation can be extended beyond next year and address the many issues facing California.■

# THE OUTLOOK FOR CALIFORNIA'S REGIONS

The following articles discuss economic trends and the outlook for the state's three regions — Southern California, Northern Coastal California, and the Central and Mountain counties. The map on this page shows the geographical definitions of those areas.

☐ Northern Coastal California
▩ Central and Mountain Counties
☐ Southern California

## OUTLOOK FOR CALIFORNIA'S REGIONS

California's three regions all showed signs of the beginnings of recovery during the first half of 1983, with most of the momentum provided by consumer spending. During the second half of 1983 and 1984, continuation of the consumer-related upturn is anticipated, and business spending, which has been in the doldrums since 1980, should show rapid percentage gains. The 1984 Olympics and real increases in defense spending should add to the recovery underway in the Southland, while the Northern Coastal region's high tech manufacturing sector appears poised for a period of expansion. The outlook for the Central and Mountain counties is enhanced by that region's relatively affordable home prices and a resumption of new business development and economic diversification.

## SOUTHERN CALIFORNIA

During the first half of 1983, a housing- and consumer-led economic recovery got underway in Southern California. Reflecting a national pattern, the region's economy is expected to remain on a recovery path through 1984, which should stimulate the still weak industrial building and commercial aircraft manufacturing sectors. Two important factors benefitting the Southland's economy over the next 18 months are real increases in U.S. defense expenditures and the boost to tourism provided by the 1984 Olympics.

### Signs of the Recovery

In the first six months of 1983, recovery was largely limited to the recession-weakened credit-sensitive sectors, as lower inflation and interest rates combined with strong pent-up demand. The Southland's housing unit authorizations during the first half of 1983 were double the depressed year-earlier total, and home resale activity also accelerated as 1983 progressed. Reflecting the housing pickup, sales of home furnishings and appliances and building materials also began to turn up in the first half of 1983.

Another recession-weakened sector showing marked improvement through mid 1983 was automobile sales. Figures from the California Department of Motor Vehicles show an 11.4 percent increase in new car registrations in the state between the first six months of 1982 and the corresponding period this year.

Because there is usually a time lag between increased economic activity and improved labor market conditions, it is not surprising that the region's employment levels did little more than stabilize during the first half of 1983. Total nonagricultural wage and salary employment has been gradually increasing since December, and the unemployment rate in June was down 1.3 percentage points from November's 10.9 percent cyclical high point.

### Basic Industries to Improve Slowly

Over the next 18 months, increased activity is anticipated for the region's basic industries, some of which had not yet begun to recover by mid 1983. For example, even with national defense expenditures up in real terms during the 1983 fiscal year (fy), the timing of key defense projects affecting the Southland along with continued modest layoffs in the commercial aircraft sector caused the Southland's aerospace employment to increase only slightly in the first six months of the year. A somewhat brighter outlook should characterize aerospace-electronics through 1984 but no boom is anticipated. Commercial aircraft orders should rise in the wake of expected improvement in airline passenger traffic and profits, and defense expenditures — estimated to increase at least five percent in real terms during fy 1984 — will continue to benefit Southland companies. But the pickup in commercial aircraft production through 1984 will be limited by the airlines' still weak financial condition and a large number of used aircraft on the market. And with the largest defense projects — such as the B-1 bomber — not entering full production until around 1985, the increases in aerospace employment through next year are likely to be below the rapid gains of the late 1970s.

Other important basic industries should also be characterized by a mixed recovery. The region's tourism sector stands to benefit from rising personal incomes, low inflation, improved labor market conditions and pent up demand for vacation travel, but competition is likely to remain strong for tourist dollars as consumers spend selectively. And foreign visitor spending stands to be limited by the high value of the U.S. dollar. The Southland has a number of new visitor draws, and of course the Olympic Games will be the major stimulus to increased tourist spending in 1984. In total, the quantifiable economic impact of the 1984 games on Southern California is estimated at $3.3 billion or about 1.5 percent of the region's total gross product.

The high value of the U.S. dollar also has been a principal force behind the recent sharp slowing in the Southland's international trade — particularly export activity. Data for the first five months of 1983 show exports 1.7 percent below the like 1982 period and imports 0.8 percent higher. This year and next, the consumer-led recovery in the U.S. should stimulate a significant pick-up in imports through the Southland's customs districts. But the recovery in export activity will be slowed by the continued high value of the U.S. dollar and slow recoveries anticipated for the region's key Asian trading partners.

Southern California's motion picture industry — the basic industry for which the region is perhaps best known — tends not to follow the broad swings of the economy. Motion pictures are a relatively inexpensive form of entertainment, and box office trends depend much more on the appeal of individual films than on cyclical economic factors. The recession year of 1982 was an all time record year for box office receipts, and that record may well be surpassed this year in light of the immense popularity of "Return of the Jedi" and the strong performance of several other movies.

Notwithstanding the strong box office performance so far this year, the industry is going through a period of transition. A number of filmed entertainment companies have been diversifying into related fields — such as pay/cable television — and it will take time to assess the profitability of such ventures.

## Construction Outlook Mixed

The rapid surge in the Southland's housing sector during the first half of 1983 in part reflected strong pent-up demand carried over from the recession, and residential building permit activity during this period was somewhat stronger than appears warranted by housing affordability considerations. Because many would-be buyers cannot qualify for loans at current home prices and mortgage rates, some moderation in the region's housing permit levels is anticipated in the second half of 1983, with activity trending gradually upwards during 1984. For all of 1983, Southern California's total housing unit authorizations are estimated at 78,000, and the 1984 figure is projected at 80,000.

A surge in office building activity enabled Southern California's total nonresidential construction to hold up well during the 1980-82 recession, notwithstanding steep declines in industrial construction. And figures for the first half of 1983 showed that nonresidential construction in the Southland was down only slightly from the corresponding year-earlier period. Office building has slowed substantially in some areas — reflecting high vacancy rates. Industrial and institutional permit activity declined between the first half of 1982 and the first half of 1983, but nonresidential alterations and additions and some office markets have exhibited strength. Part of the region's nonresidential construction activity results from building projects related to the 1984 Olympics — e.g. Olympic sites, new hotels, and expansion of Los Angeles International

**SELECTED ECONOMIC INDICATORS: SOUTHERN CALIFORNIA**

| | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|
| Growth in Total Wage & Salary Employment (%)* | 3.9 | 5.7 | 7.4 | 5.1 | 1.5 | 1.6 | –1.8 |
| Real Growth in Taxable Retail Sales (%)** | 8.0 | 12.9 | 8.0 | 2.7 | –5.2 | 1.8 | –2.9 |
| Increase in Consumer Price Index (%) | 6.6 | 6.9 | 7.3 | 10.8 | 15.7 | 9.8 | 6.0 |
| Unemployment Rate (%)* | 8.8 | 7.8 | 6.6 | 5.5 | 6.3 | 6.7 | 9.3 |
| Annual Net Migration of Population (000) | 122.1 | 148.6 | 158.7 | 147.9 | 138.9 | 131.4 | 166.4 |
| Annual Housing Unit Authorizations (000) | 122.9 | 153.4 | 134.9 | 111.9 | 77.0 | 59.2 | 41.4 |

*Based on data for Los Angeles, Orange, Riverside, San Bernardino, San Diego, Santa Barbara, and Ventura counties.

**Adjusted for the "commodities less food" component of the Los Angeles - Orange County Consumer Price Index.

Over the next 18 months, increased manufacturing should lead to a pickup in industrial construction — a sector that has been declining for three years. Overall, the region's total nonresidential construction activity is projected to remain flat for all of 1983, and a rise of 5-10 percent is projected for 1984.

### Labor Markets to Improve Slowly

Continuation of the recovery over the next 18 months should enable gradual improvement in Southern California's labor market conditions. Total nonagricultural wage and salary employment for the region's six metropolitan areas is projected to increase 1.0-1.5 percent for all of 1983 — reversing the year-earlier decline — with the rate of nonfarm employment growth in 1984 expected to exceed 3.5 percent. Job growth through next year will be concentrated in the labor-intensive service producing activities and in construction and manufacturing — the sectors most weakened by the recession. For all of next year, the unemployment rate for Southern California's six metropolitan areas is projected to average 8.5-9.0 percent — down from 9.5-10.0 percent for all of 1983.

## CALIFORNIA'S CENTRAL AND MOUNTAIN COUNTIES

The initial stimulus for recovery in California's Central and Mountain counties — like the state as a whole — came from increased consumer spending in early 1983. Modest declines in interest rates and increased confidence in the nation's economic performance, coupled with the sizable pent-up demand for consumer goods, led to improvement in retail trade, homebuilding, and real estate activity in 1983's first two quarters. Nonetheless, while many businesses benefitted from increased consumer spending during the first half of 1983, industries such as manufacturing and nonresidential construction showed little improvement as the year progressed. Additionally, the region's important agricultural sector has exhibited mixed trends in 1983. The effects of poor weather conditions earlier in the year and the implementation of new government programs — particularly P.I.K. — will likely limit both crop production and gross farm income, but lower operating costs should help to sustain farmers' net profits in 1983.

Although some employment sectors have shown modest gains in 1983, total wage and salary employment in the region's seven major metropolitan counties registered a 0.4 percent annual decline in the first half of the year. Modest job growth occurred in retail trade and services, but those year-over-year gains of 1.5 percent and 0.2 percent, respectively, could not offset job declines in other major employment sectors.

After expanding at a 4.4 percent annual rate in 1982, growth in the region's civilian labor force moderated slightly in the first half of 1983 — slowing to a 3.8 percent year-over-year expansion. But the decline in total employment, combined with continued growth in the number of job seekers, caused the unemployment rate this past June to average 13.3 percent for the region's seven major metropolitan counties (Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus, and Yolo counties).

It is unlikely that the region's unemployment rates will improve meaningfully during the remainder of 1983, although growth in the civilian labor force has slowed in recent months. Seasonally-adjusted unemployment rates will probably average 14.0-14.5 percent for all of 1983, although rates should trend moderately downward through the remainder of 1983 and into 1984.

### Construction Trends Mixed

Similar to other regions of California, homebuilding activity in the Central and Mountain counties improved significantly in 1983. In the 33-county area, the number of housing units authorized for construction during the first six months of the year totaled 14,523 — a healthy 117 percent gain over the year-earlier period.

Residential construction is likely to show more moderate growth rates through the remainder of this year as a modest rise in interest rates, coupled with an increased inventory of available housing, could limit homebuilding. For all of 1983, nonetheless, the number of housing unit authorizations for the Central and Mountain County region is expected to reach about 38,000 — nearly 60 percent above the 1982 level.

### Key Industries Slow to Recover

The region's important lumbering sector has been plagued by lumber mill shutdowns and cutbacks related to both the depressed condition of the construction industry and changes in the internal operating structure

of lumber milling. The lumber and wood products category of manufacturing has shown no job growth over last year's depressed level. The upturn in residential construction in 1983 has, however, resulted in modest improvement in lumber demand (the value of California's harvested timber could advance as much as 15 percent annually in 1983). The outlook for California's lumbering operations is not optimistic over the near term. It will be several years before the industry can modernize or reopen many facilities. Moreover, a strong and sustained recovery in homebuilding will be necessary to insure the high demand for lumber needed to revitalize this sector.

In the first half of 1983, the region's retailers saw the beginning of a recovery in consumer spending. First quarter figures from the State Board of Equalization show a 3.8 percent year-to-year gain in taxable retail store sales in California's Central and Mountain counties. That increase outpaced the state growth rate of 1.8 percent for the comparable period. Increased personal incomes, rising consumer confidence, and pent-up demand are likely to keep this sector on a recovery path through the remainder of the year.

Manufacturing activity in Central California reported a weak first-half performance again in 1983, although production appears to have improved slightly from the 1981 and 1982 depressed levels. One indicator for measuring manufacturing activity in the region is industrial power usage, and in Sacramento County, power usage advanced 1.3 percent in the first half of 1983 compared with the year-earlier level. While the region's manufacturing payrolls have not yet reflected the improvement, employers in the region gradually increased workers' hours during the first half of the year — a trend which should continue as manufacturing orders pick up. In the nondurable goods sector, payrolls should show seasonal expansion in food processing plants as fall harvests begin, but a number of processors have closed or scaled down operations during the past year, an indication that the cyclical rise in the number of food processing workers may not be as strong as in past harvest seasons. In the durable goods sector, the potential for expansion of high technology manufacturing in the region is good, and advances in that sector will depend heavily on the nationwide recovery in "high tech" markets.

Some of California's largest petroleum reserves are located in Central California's San Joaquin Valley, making oil production an important economic activity for the region. However, lower oil prices and weakened demand for petroleum products during the 1981-82 recession created an oversupply of crude oil and brought drilling activity nearly to a halt. Petroleum production in the San Joaquin Valley showed little growth in early 1983, advancing slightly over 2 percent annually during the first four months of the year.

## SELECTED ECONOMIC INDICATORS: 33 CENTRAL AND MOUNTAIN COUNTIES OF CALIFORNIA

| | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|
| Growth in Total Wage & Salary Employment (%)* | 3.8 | 4.1 | 5.9 | 4.8 | 2.0 | 1.6 | –1.0 |
| Real Growth in Taxable Retail Sales (%)** | 8.0 | 11.2 | 9.2 | 3.2 | –8.2 | 0.2 | –2.2 |
| Total Gross Farm Revenue (In $ Millions)*** | 5,758.9 | 5,945.7 | 6,281.7 | 8,651.3 | 9,685.8 | 9,406.1 | 8,926.7 |
| Unemployment Rate (%)* | 10.1 | 9.8 | 9.1 | 8.4 | 9.1 | 10.2 | 13.4 |
| Annual Net Migration of Population (000) | 76.9 | 84.8 | 82.2 | 82.6 | 79.0 | 73.5 | 74.5 |
| Annual Housing Unit Authorizations (000) | 53.5 | 63.6 | 62.6 | 58.3 | 35.3 | 25.4 | 23.9 |

*Based on data from Fresno, Kern, Placer, Sacramento, San Joaquin, Stanislaus, and Yolo counties.

**Adjusted for the "commodities less food" component of the Consumer Price Index.

***Includes Central California's 26 major farm counties.

Drilling activity, on the other hand, gradually increased as the year progressed — totaling 1,228 wells through July 1983, a 3.3 percent yearly gain. But although drilling activity is beginning to pick up in the San Joaquin Valley, it is not likely that it will approach the high levels reached in 1981 of 2,085 wells.

In total, the strength of economic recovery in California's Central and Mountain counties will depend on a number of national and local trends. The housing recovery should continue to be stimulated by the region's high population growth, new business development, and relative home affordability. But some moderation in the rate of homebuilding growth might be expected through the remainder of the year. The retail trade and service industries should benefit from population growth; and as disposable incomes continue to rise — stimulated by increased job stability, lower inflation rates, and the midyear tax cut — retail and service businesses are expected to show gradual improvement in 1983 and 1984.

The region's important agricultural sector has benefited from a leveling off of operating costs in 1983 which should help net farm income for the year. Production levels, on the other hand, may not be as high as in previous years, due to adverse weather conditions and the large amount of acreage set aside in new government programs.

Because agriculture is a major industry in Central California, its performance often affects other sectors of the economy such as food processing, sales of farm and irrigation equipment, chemicals, and transportation. Therefore, economic growth in 1983 and 1984 for these industry sectors will strongly depend on farm income and yields.

Continued diversification of Central California businesses in recent years has helped the region to weather the cyclical economic patterns of sectors such as agriculture. And as the national economy strengthens, the expansion of new businesses and industries in this region is expected to continue at a healthy pace.

## NORTHERN COASTAL CALIFORNIA

The Northern Coastal California economy showed some encouraging signs during the early months of 1983. As the first half of the year proceeded, evidence mounted that the protracted and deep recession of 1981-82 had ended and the long-awaited recovery had begun. Especially encouraging was the turnaround in the housing industry and in consumer spending. The revival in housing provoked recoveries in numerous other sectors, including the lumber industry in the North Coast counties of Humboldt and Mendocino. As the economic news turned more cheerful, consumer spending picked up. Sales of home furnishings and autos staged a comeback from the depressed levels of the prior three years. And after three weak years, the region's major airports experienced a strenghening in traffic during the first half of 1983 in response to air fare discounts and the economic recovery. Perhaps the most notable achievement of the first six months of 1983 was in regards to prices: inflation came literally to a halt.

The recovery that commenced at the start of the year should accelerate and spread to other sectors of the local economy. Sufficient momentum was built up from January through June to keep the Northern Coastal economy moving forward through 1983. The rebuilding of inventories alone should provide stimulus to business activity, but there will be other forces at work to keep the economy on a recovery track. The midyear personal income tax cut and low inflation will boost incomes and encourage further consumer spending. Additional impetus will be provided by rising defense spending. On the negative side, exports will continue to be hampered by the high value of the dollar and weak economic growth abroad. Nonresidential construction, too, could go counter to general economic trends, although it has continued to hold up well in spite of rising vacancy rates for office space.

### Labor Markets — Slow to Improve but Second Half More Promising

As is generally the case in the early stages of recovery, the region's labor markets were subdued during the first six months of 1983. Job layoffs were less common but not entirely absent, and job openings were scarce. The number of nonagricultural jobs remained virtually unchanged between January and June of this year, and there were fewer jobholders at midyear 1983 than a year earlier. By sector, only wholesale and retail trade registered any significant job gains during the first six months of 1983. The slowness of the local labor markets to respond to the recovery may reflect the region's minimal reliance on those industries that were among the first to recover from the recession — for instance forest products and auto assembly. The third and fourth quarter employment figures should look

## SELECTED ECONOMIC INDICATORS: NORTHERN COASTAL CALIFORNIA

| | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|
| Growth in Nonagricultural Employment (%) | 3.7 | 4.7 | 6.0 | 4.8 | 3.5 | 1.5 | –0.5 |
| Real Growth in Taxable Retail Sales (%)* | 9.1 | 11.7 | 3.3 | 4.5 | –3.5 | –3.4 | –2.3 |
| Annual Increase in Consumer Price Index (%) | 5.6 | 7.6 | 9.4 | 8.5 | 15.2 | 12.8 | 7.5 |
| Unemployment Rate (%)* | 8.7 | 7.5 | 6.3 | 5.7 | 5.9 | 6.5 | 8.5 |
| Annual Net Migration of Population (000) | 46.5 | 41.5 | 31.3 | 33.5 | 44.3 | 35.9 | 31.6 |
| Annual Housing Unit Authorizations (000) | 45.5 | 53.7 | 46.3 | 39.9 | 32.5 | 20.2 | 18.7 |

*Adjusted for inflation with the "commodities less food" component of the San Francisco - Oakland area Consumer Price Index.

considerably brighter, as the recovery proceeds. With the possible exception of the overcrowded videogame and home computer fields, the Bay Area's electronics industry is poised for a strong second half. In late spring, a surge in semiconductor orders had already prompted companies to recall workers. The cautious hiring stance of companies should wane as the recovery becomes more permanent and memories of the 1981-82 recession fade.

Job growth for all of 1983 will be modest — under one percent — but better than last year's 0.5 percent decline. Most of the additional jobs are anticipated in segments of the high-tech sector, business services, and retail trade. Deregulation is clouding the employment outlook in the transportation and communication industries, and job prospects in health care are more difficult than usual to assess, in part because of the implementation of federal and state government cost-containment programs. Public sector employment, which continued to shrink during the first half of 1983, is not likely to grow in the second half either, given the precarious financial condition of state and local governments. In 1984, an acceleration in job growth can be expected as the recovery becomes more widespread among industries.

Northern Coastal California's unemployment rate reached a cyclical peak of 9.6 percent (seasonally adjusted) in November of last year and edged lower in the subsequent months. The June rate stood at 8.8 percent. The recent peak was the highest recorded since 1975 but compares very favorably with the 10.8 percent high recorded for the U.S. in December of 1982 and the 11.2 percent cyclical peak registered for the state in February of this year. The region's unemployment rate should continue to trend downward through 1984. At the end of 1983, the unemployment rate could be close to the 8 percent mark, and should average about 8.6 percent for the entire year.

### Consumers Return to the Market

Retail markets, which were in the doldrums throughout most of 1982, showed some positive signs in the first half of this year. Consumers, reluctant to spend in 1982, turned more confident and free spending in the first and second quarters of 1983. Auto sales perked up as did spending for recreational vehicles, building materials, and appliances. The improvement was broad in scope, with very few retail sectors not enjoying revenue gains in inflation-adjusted dollars.

Retail markets could be even stronger in the second half of the year than in the first. Consumers' financial positions are quite strong, with liquidity high and debt service payments low. Consumer purchasing power stands to benefit from the July 1 personal income tax cut as well as from rising employment and low inflation. For these reasons, the Northern Coastal region's retail markets should fare quite well for all of 1983 — the year could easily turn out to be the best since 1979.

## Housing on the Rebound

Housing was one of the first sectors to recover from the 1981-82 recession. Both homebuilding and housing sales began to recover in the late fall of 1982, after mortgage rates had dropped from the high teens, and the upward trend continued until mid 1983 (the latest figures available). Permits during the first six months of the year were running 89 percent above the severely depressed year-ago levels. The dollar volume of mortgage loans closed by California's S&Ls more than tripled during the first six months of 1983 compared with the like period in 1982. Real estate deeds recorded, an indicator of sales activity, were up 19.3 percent in the San Francisco Bay Area during the first three months of 1983, compared with 1982's first three months. Much of the home sales activity was concentrated in the lowest and highest price ranges.

With interest rates firming at midyear, the momentum of the region's housing recovery is unlikely to accelerate in the second half of 1983, and could actually stall. But mortgage rates are not expected to return to last year's high levels, and gains in income and continued softness in home prices should begin to narrow the "affordability gap." For all of 1983, about 27,300 dwelling units are forecast for the entire region — a 46 percent increase over the record low in 1982 of 18,700 units. A more modest expansion is projected for 1984, when dwelling unit authorizations are expected to total slightly less than 28,000.

## Tourism More Active

Northern Coastal California's tourist trade should be more active this year than last year. The restoration of consumer confidence, a brighter economic picture, and rising income should encourage more travel. The travel business will likely show an improvement for all of 1983 over the dim performance of the prior two years. The recent pickup in the sales of recreation vehicles is another indication of people's desire to travel. Unfortunately, the number of foreign travellers to the region could very well decline because of the high value of the dollar on foreign exchange markets.

The year 1984, of course, will not be typical since tourism spending will be uniquely influenced by the Olympic Games in Southern California and the Democratic National Nominating Convention in San Francisco. Both events are expected to benefit wide areas of the state. ■

# THE SHORT-TERM U.S. OUTLOOK

## U.S. OVERVIEW

### Surprisingly Strong Recovery

The recovering U.S. economy has recently demonstrated a vitality that has taken many observers by surprise. The second quarter's growth in real GNP was put at more than 9 percent, and the third quarter estimate is only a point or two less. That two-quarter surge in real output has led to gains in employment and income that place the economy on a much sounder footing. There have been some expressions of alarm that this generally unanticipated burst of growth could lead to renewed inflationary pressures. We think that there is not much risk of higher inflation when unemployment still exceeds 9 percent and some businesses are still closing shop permanently. The growth is welcome news at this point.

Now that November, 1982, has been sanctioned as the low point of the recession that began in July, 1981, the current recovery will soon be one year old. That is still quite young by the standard of the last six peacetime (excluding 1961-1969) business cycles, which had expansionary periods averaging about 36 months. We think there is a high probability that the current economic expansion will be close to average in both strength and duration when compared to those prior peacetime cycles. Our current forecast of real GNP projects a growth rate of 5.8 percent from the fourth quarter of 1982 through the fourth quarter of 1983, and a 4.0 percent gain over the following four quarters.

Although the boom of Spring and Summer appears to be moderating now, the economy is still much healthier than it was a year ago. Consumer confidence, as well as tangible buying plans, are still on the increase. Household wealth is up strongly from last year, as are employment and disposable income. Corporate profits are improving rapidly, and business purchases of capital equipment are gaining sooner and faster than expected. Inflation is still moderate, as are wage gains, and productivity is climbing at a healthy rate. Even the federal deficit has a positive side: new defense orders are very stimulative to the recovering economy. Growth of the money supply appears to be moderating. These are all factors that should help to sustain the economic expansion well into 1985.

### Potential Problems

There are problems, but they seem to be manageable at this point. Interest rates have turned up, especially for long-term borrowers, and real interest rates appear to be very high. Increases so far have been moderate, however, and serve to act as a brake on potential runaway demand situations. Only in the construction area do we see a significant risk that the recovery could be stalled by interest rates, and that slowdown is likely to be only temporary.

The international debt of underdeveloped countries remains a critical problem, but one whose adverse effects are likely to be absorbed over a very long period of time. Unemployment is still very high and there is much idle capacity in American industry, but the recovery is rapidly putting both labor and capital back to work. The most menacing domestic problems are the federal deficit, which appears to be containable for 1984, and the recent bulge in money growth, which is likely to give way to more moderate growth.

### Consumer Spending

Retail spending for cars, trucks, boats, recreational vehicles, and airplanes has recovered strongly in 1983 and should have an even more memorable year in 1984. Other durable goods, including furniture, appliances, and consumer electronics, should also see a strong growth trend. Consumer spending for nondurable goods should be strongest for clothing and shoes, with a relatively weak outlook for purchases of gasoline and other petroleum products. Consumers will also spend more money on services, principally in the housing, transportation, and medical categories.

## Housing

The prospects for residential construction will mainly rise and fall with interest rates. We expect 1983 to end at a reduced level of building activity, with fourth quarter housing starts lower by several hundred thousand units than the first half, 1983, level of 1.7 million. Residential mortgage interest rates have recently moved up again, and will probably exceed 13 percent throughout 1984 as credit demands expand. The housing situation should nevertheless improve next year, as gains in employment and income will offset some of the damage to housing affordability caused by high mortgage rates.

## Capital Spending

Business outlays for durable equipment have been gaining steam, and should see a good expansion in 1984, reflecting the improving picture for sales and profits, as well as necessary modernization expenditures in basic industries. Business spending for structures is still being pared due to widespread excess capacity, and probably will not show any significant growth until late this year or early in 1984. Although inventory building is likely to proceed more gradually than in past expansions, the fact that almost $150 billion in inventories have been liquidated since the beginning of 1982 indicates a large potential for re-stocking of empty shelves.

**FORECAST HIGHLIGHTS**
**1982-1984**
**(Billions)**

| | 1982A | 1983F | 1984F |
|---|---|---|---|
| Gross National Product | 3073.0 | 3313.3 | 3650.4 |
| % Change | 4.0 | 7.8 | 10.2 |
| Real GNP (1972 $) | 1485.4 | 1532.8 | 1604.9 |
| % Change | –1.9 | 3.2 | 4.7 |
| GNP Deflator (1972 = 100) | 206.9 | 216.1 | 227.4 |
| % Change | 6.0 | 4.5 | 5.2 |

A = Actual F = Forecast

## Government Spending

The government sector, on balance, will not be making much of a contribution to this economic recovery. Although the federal government is providing a heavy stimulus through its defense orders, the large federal budget deficit and the pressures that it imposes on interest rates are effectively nullifying much of the stimulus. The federal government's share of total output is likely to rise next year, primarily reflecting the strength of defense spending. State and local government is severely strapped for revenue, and is likely to show only a slight increase in spending next year.

## Net Exports

The current strength of the U.S. dollar, which recently established all-time highs against several other currencies, is slowing the recovery in the export sector. The dollar's strength is due importantly to higher relative real interest rates in the U.S. and to a high level of international uncertainty — making the dollar a haven. The large current account deficit of the U.S. will ultimately result in a weakening of the dollar, late this year and next. A weaker dollar will result in a better outlook for U.S. exports in 1984, when import demand should be moderating along with domestic consumption.

## Inflation Outlook

There is a high probability that inflation rates will remain within the 5 to 6 percent range throughout next year. Food is about the only major commodity group that is showing an acceleration in inflation, and that is mainly due to supply shortages brought about by a combination of acreage reduction under the federal government's Payment-In-Kind program and extremely poor summer weather virtually nationwide. These pressures are not viewed as the beginning of a cyclical swing in commodity prices, which would typically be due to increased demand. Energy products, housing, transportation, and apparel goods, which are the major components of consumer prices in addition to food, all are characterized by moderate inflationary pressures. Wage rates are still moderate, and productivity is rising, further reducing cost pressures in the economy. The cost of capital, in spite of the current uptrend in interest rates, is down substantially from last year.

## MONETARY POLICY AND FINANCIAL MARKETS

Financial markets have been put through another difficult year thus far in 1983. The difficulties stem primarily from regenerated concerns that the Federal Reserve is embarked upon a highly stimulative course which will inevitably lead to a flare-up in inflation. These fears stem from the very rapid expansion of M1 since the middle of 1982. (M1 is composed of currency, demand deposits, all other checkable deposits and travelers' checks). They are made very real by the prospects of extremely large budget deficits into the foreseeable future, since these deficits may ultimately force the Federal Reserve onto a more expansionary course than desired.

There is no question that M1 growth has been extremely rapid over the past year. From July 1982 to July 1983, M1 expanded almost 13.5 percent compared with only 5.2 percent in the prior year. It is important to remember, however, that M1 has been biased upward by the new interest-sensitive Super-NOW accounts (which were instituted in January 1983 and included in M1). These accounts, even more than the older NOW accounts, give M1 a savings element, rather than representing only transactions balances, and they will unquestionably make it behave differently over the economic cycle. This interest-sensitive component of M1 will continue to expand even with rising interest rates, taking larger rate rises to slow M1 growth and implying a less clear-cut relationship between M1 and inflation than held historically.

Persistent and large prospective budget deficits promote higher inflation fears because at this stage of the economic cycle private credit demands will also start to rise. In fact, consumer and mortgage borrowing is already on the rise. But the uptick in private credit demands will be fairly modest next year, since strength in consumer and mortgage borrowing will be tempered by soft business borrowing through much of 1984. A clash between public and private credit demands will come eventually if substantial progress is not made on the size of deficits, but that clash is far from imminent.

### Outlook for Policy and Interest Rates

For the remainder of 1983 and into 1984, monetary policymakers will cautiously continue their attempt to bring the money aggregates under control. The caution will result from their concerns about stalling out the U.S. recovery and about financial strains imposed on foreign debtor nations. Policymakers have already indicated a willingness to tighten credit policy modestly very early in this recovery cycle, however. At its July meeting, the FOMC voted to increase slightly the degree of reserve restraint. This policy decision was the third such tightening since the beginning of May, 1983.

A further, small tightening step might be required later in 1983. After the turn of the year, however, both slackening economic and money growth will allow interest rates to soften for several months. As year-end 1984 is approached, though, business credit demands will clearly be rising in addition to consumer and mortgage needs. These credit needs, coupled with only a small reduction in the Treasury's appetite for funds, will push rates higher again.

Thus, in the year ahead, the overall effect of Federal Reserve actions and the economy will be to push interest rates marginally higher on average. There will, as always, be ups and downs throughout the year, as described above. But the prime should average approximately 11.25 percent, compared with approximately 10.75 percent in 1983, and seasoned high-grade corporate bonds are expected to move only slightly higher on average next year after approaching an average of 12 percent in 1983.

## FISCAL POLICY AND GOVERNMENT SPENDING

Federal fiscal policy should remain highly stimulative through 1984, with a unified budget deficit of $207 billion in the current fiscal year and $180 billion in 1984. For the current fiscal year, unified budget receipts are projected to reach $600 billion, some 3 percent below the fiscal 1982 level. The slowing in the growth of federal receipts in recent years has been substantial. From FY 1976 through FY 1981, receipts grew at an average annual rate of 14 percent. In contrast, receipts will have shown essentially no growth from 1981 through 1983. In addition to the decline in real economic activity, this slowdown reflects the reduction in the rate of inflation and the tax cuts enacted in 1981. Outlays in FY 1983 are projected to reach $807 billion, an 11 percent increase over the previous year's total. From 1976 through 1981, outlays grew at an average annual rate of 12 percent, slowing to 11 percent over the past two years.

The outlook for fiscal year 1984 remains somewhat clouded, with the Administration and Congress in conflict over budget priorities. According to midyear estimates, the Administration's budget proposal would yield receipts of $668 billion and would result in outlays of $848 billion, for a unified budget deficit of

$180 billion. In contrast, the Congressional Budget Resolution, adopted on June 23, 1983, would generate receipts of $667 billion and outlays of between $860 and $868 billion. The larger estimate includes monies for additional domestic spending measures that would be released upon enactment of authorizing legislation. The underlying differences in the revenue and outlay projections are greater than simple comparisons of the totals imply. The Administration's proposal calls for additional revenue measures of $3 billion, whereas the Congressional resolution incorporates $12 billion of receipts above current law levels. Furthermore, the resolution calls for $2 billion less in defense outlays and for between $13 and $21 billion more in nondefense outlays. While Congress has made considerable progress in passing 1984 appropriation bills, action on the revenue and spending measures contained in the budget resolution's reconciliation instructions has been postponed until Congress returns in September.

The federal budget outlook on a National Income Accounts basis is shown in the accompanying table. No significant revenue measures are assumed to be enacted for next year. Projected revenue growth reflects the continuation of the economic recovery with somewhat higher inflation and the increases in both the Social Security taxable wage base and tax rate scheduled for January 1. Personal tax and nontax receipts will continue to grow in 1984, as both real economic growth and inflation interact to increase the tax base and applicable tax rates. The growth of corporate profits tax accruals is restrained by the accelerated depreciation expense provisions, enacted over the past two years.

In 1984, federal outlays are projected to rise 6 percent. Federal purchases of goods and services are projected to rise 13.5 percent in 1984, after slowing to 7.9 percent in 1983. In terms of constant dollars, federal purchases should rise 6.4 percent in 1984, following a 1.9 percent increase in the current year. A major factor accounting for this spending pattern is the payment-in-kind (PIK) program of the Commodity Credit Corporation. Under this program, farmers who participate in the acreage reduction program will be compensated with actual crops from the government surplus rather than with cash.

The forecast for defense purchases essentially assumes the implementation of the defense program adopted by Congress in last year's budget resolution. Federal military and nonmilitary personnel are projected to receive a 4 percent salary increase, effective January 1, 1984. The balance of projected defense outlays reflects not only new spending authorization but also spending associated with procurement appropriations of recent years. Real defense spending is expected to increase some 9 percent in both 1983 and 1984.

## CONSUMER SPENDING

It is almost a truism to say that consumer spending is fueling a very broad-based recovery in the U.S.

**FEDERAL BUDGET OUTLOOK**
**NATIONAL INCOME ACCOUNTS BASIS**

| Current $ Billions / Calendar Years | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| Receipts | 627.0 | 617.4 | 660.0 | 748.9 |
| Outlays | 689.2 | 764.4 | 823.6 | 902.2 |
| Purchases of Goods and Services: | | | | |
| Defense | 154.0 | 179.4 | 204.0 | 234.8 |
| Nondefense | 75.2 | 79.3 | 73.9 | 77.2 |
| Deficit | 62.2 | 147.0 | 163.6 | 153.3 |
| **As Percentage of GNP** | | | | |
| Receipts | 21.2% | 20.1% | 19.9% | 20.5% |
| Outlays | 23.3% | 24.9% | 24.9% | 24.7% |
| Deficit | 2.1% | 4.8% | 5.0% | 4.2% |

economy. Indeed, it would be difficult to engineer a recovery without the participation of the consumer, since the household sector typically accounts for more than 60 percent of GNP in the U.S. By comparison, the Japanese economy devotes only about half of real output to consumer goods and services.

The pace of the spending revival thus far is typical of other post-World War II business expansions, in which real consumer outlays typically rose 6 to 7 percent during the first year of recovery. This strength could be considered somewhat surprising in view of the high level of interest rates that still prevails. It is not so surprising when we look at the other reasons.

## Why It Is A Strong Recovery?

The current surge in consumer spending reflects an improvement both in consumer confidence and in the basic determinants of consumer spending, including lower interest rates, higher asset levels, lower debt burdens, and rising income and employment levels. This improved spending climate follows a three-year lull, from the end of 1979 through the end of 1982, in which real consumer spending in the U.S. grew only 1 percent per year, explaining much of the decline in total output during that period.

The sharp drop in interest rates that occurred in the second half of 1982 set the stage for a strong consumer-led recovery in the first half of 1983. The credit-sensitive sectors of housing and consumer durable goods responded strongly to lower rates. The dramatic improvement in consumer confidence also benefited retail spending for nondurable goods and services.

The adverse economic circumstances of the 1980-1982 period led to a fundamental improvement in consumer balance sheets, which has helped fuel the economic recovery that began in late 1982. High interest rates during 1980-82 discouraged spending and encouraged saving and debt repayment. Households were able therefore to rebuild their stock of financial assets, which had been eroded substantially by the inflationary spending boom and low real after-tax returns of the mid-to-late 1970s. Inflation-adjusted household financial assets have been boosted even further, by close to 15 percent since mid-1982, by the sharp increase in the market value of equities.

The household debt burden has also improved substantially in recent years. As measured by the ratio of consumer installment debt outstanding to disposable personal income, the consumer debt burden declined from its all-time high reading of 17.8 percent in the fourth quarter of 1979 to 15.2 percent during the final quarter of 1982, its lowest reading since 1976.

The improving consumer sector also is enjoying a strengthening of employment and after-tax income. The civilian unemployment rate, which peaked at a reading of 10.8 percent last December, had fallen to 9.5 percent by July. Real personal after-tax income improved as well in the first half of 1983, and it is getting a further boost from the July tax cut, which came at a very auspicious time for the recovery in consumer spending.

## Autos and Other Durable Goods

Durable goods purchases, as usual, are showing the sharpest gains during the first year of recovery. The automotive sector, which was severely depressed until very recently, is leading the surge. Although there is some reason to believe that the automobile replacement cycle may have lengthened on a long-term basis, there is also no doubt that a large volume of purchases has been postponed during the last several years of tight money and economic weakness. Total auto sales during 1982, at 8 million units, were the weakest in about 20 years, as were the 5.7 million domestic autos sold last year. The first half of 1983 has seen a revival of total auto sales to an average sales rate of 8.8 million, and the June rate was 10.1 million, a level that had not been expected quite so early in the recovery.

Early 1984 should see auto sales exceeding 10 million on a sustainable basis, assuming that interest rates are not substantially higher than at present. Consumer spending for home furnishings and appliances has also made a strong contribution to the revival in consumer spending, and should continue to expand at a 5 to 6 percent real growth rate through 1984 as new home purchases recover to near pre-recession levels.

## Nondurable Goods

Consumer spending for nondurable goods generally shows less sensitivity to the business cycle than durable goods, since the latter are more easily postponed by most households. Food and beverages typically account for about half of consumer spending for nondurable goods, and are expected to increase at a 2 to 3 percent real annual rate through 1984. Clothing and

## ECONOMIC OUTLOOK

**Selected Economic Indicators**

| | 1983 | | | | 1984 | | | | Annual | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Item | IA | IIP | IIIF | IVF | IF | IIF | IIIF | IVF | 82A | 83F | 84F |
| Housing Starts (Millions) | 1.69 | 1.69 | 1.68 | 1.45 | 1.55 | 1.60 | 1.65 | 1.70 | 1.06 | 1.63 | 1.63 |
| Automobile Sales (Millions) | 8.4 | 9.2 | 9.6 | 9.8 | 10.0 | 10.2 | 10.4 | 10.6 | 8.0 | 9.3 | 10.3 |
| Unemployment Rate (percent) | 10.4 | 10.2 | 9.4 | 9.1 | 8.8 | 8.6 | 8.4 | 8.3 | 9.7 | 9.8 | 8.5 |
| Industrial Production (1967 = 100) | 138.5 | 144.3 | 148.4 | 151.0 | 153.5 | 155.9 | 158.4 | 160.7 | 138.7 | 145.6 | 157.1 |
| % Change* | 9.9 | 17.8 | 12.0 | 7.0 | 6.8 | 6.5 | 6.5 | 6.0 | –8.1 | 5.0 | 7.9 |
| Personal Income ($ Billions) | 2657.7 | 2715.7 | 2778.0 | 2845.6 | 2913.6 | 2982.5 | 3051.6 | 3117.4 | 2578.7 | 2749.3 | 3016.3 |
| % Change | 4.0 | 9.0 | 9.5 | 10.1 | 9.9 | 9.8 | 9.6 | 8.9 | 5.9 | 6.6 | 9.7 |
| Disposable Personal Income ($ Billions) | 2255.9 | 2303.0 | 2376.6 | 2431.3 | 2498.4 | 2553.0 | 2608.2 | 2660.7 | 2176.6 | 2341.7 | 2580.1 |
| % Change | 5.1 | 8.6 | 13.4 | 9.5 | 11.5 | 9.0 | 8.9 | 8.3 | 6.3 | 7.6 | 10.2 |
| Consumer Price Index (1967 = 100) | 293.5 | 296.6 | 300.1 | 303.8 | 307.6 | 311.6 | 315.8 | 320.0 | 289.1 | 298.5 | 313.8 |
| % Change | –0.4 | 4.2 | 4.8 | 5.0 | 5.1 | 5.3 | 5.5 | 5.5 | 6.1 | 3.3 | 5.1 |
| Producer Price Index (1967 = 100) | 283.4 | 283.8 | 287.0 | 290.5 | 294.1 | 298.0 | 302.0 | 306.1 | 280.6 | 286.2 | 300.0 |
| % Change | –2.6 | 0.7 | 4.6 | 4.9 | 5.1 | 5.4 | 5.5 | 5.6 | 4.0 | 2.0 | 4.8 |

*Compound annual rates

shoes, which account for somewhat less than one-fourth of the nondurable goods category, are expected to be the fastest-growing major component of nondurables through 1984, rising at a real growth rate of 3 to 4 percent. Consumer purchases of gasoline, motor oil, fuel oil, and coal have recently been shrinking in real terms, and little-to-no real growth is expected in these categories through 1984, reflecting the nation's adaptation to a lengthy period of rising prices and scarcity.

### Services

Consumer services are a diverse array of expenditure items which vary from absolute necessity (emergency medical treatment) to complete frivolity (lottery tickets). The largest major category of service spending is housing, which accounts for more than one-third of the total. Housing services measure the rental value of both owner-occupied and tenant-occupied dwellings, unlike the capital component of housing, which is considered investment. Housing services are expected to grow at about a 3 percent rate, in real terms, through 1984. Household operation is a smaller category which includes gas and electric utility purchases, water, telephone, and other household expenses, and is projected to grow less than 2 percent through 1984.

Transportation services is a relatively fast-growing category that includes the cost of operating both private and public transportation, including buses, airlines, and railroads. This category is likely to grow at about a 4 percent rate for the rest of 1983 and 1984. Medical services is a robust category that has grown at an annual rate of 3.4 percent during the last three years, and will probably accelerate to the 4 to 5 percent range between now and the end of 1984, due partly to the importance of elective treatments and medications which may be foregone during periods of economic uncertainty.

## EMPLOYMENT OUTLOOK

The back-to-back recessions in the early 1980s had a severe impact on the nation's work force. The civilian unemployment rate rose to a post-depression peak of 10.8 percent in December, 1982. Over 12 million workers were unemployed. The rate began to decline in January, 1983, and by July, it had reached 9.5 percent with sure signs of further declines.

During the recent recession, workers in the goods producing sector suffered disproportionately higher rates of unemployment. Weak consumer and corporate spending adversely affected the demand for manufactured products. Employment in the manufacturing sector dropped almost 11 percent between the pre-recession high in the third quarter of 1981 and the trough period in the fourth quarter of 1982. Over half a million manufacturing workers were terminated during that period.

The construction industry also reported a high unemployment rate. The sharp decline in the real estate business took a heavy toll on construction and its related industries. About 134,000 construction workers, or 3.2 percent of the total construction workforce, lost their jobs. Employment in the service sector remained relatively strong during the recession. In fact, service employment increased by 3.3 percent during the 16-month recession ending in November, 1982.

The emergence of millions of long-term unemployed workers created much social and political concern during the recent prolonged recession. In January 1983, about 2.7 million workers were unemployed for more than 27 weeks, and the mean duration of unemployment reached 19.4 weeks as compared to 16.2 weeks in the recession of 1973-75.

Many of those long-term unemployed were adult male primary workers who were the traditional main household earners. The situation was even worse for minority workers. The number of long-term unemployed showed the first decline since 1981 in July, 1983. Although the median duration of unemployment had fallen by 2 weeks in July to 9.9 weeks, the mean duration remained at the record high of 21.7 weeks, indicating a large number of hard-core unemployed. As the economy expands, more and more discouraged workers will reenter the work force, keeping the unemployment rate relatively high.

## OUTLOOK FOR REAL GROWTH
**(Percent Change)**

| | 1983 | | | | 1984 | | | | Years | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Item | IA | IIP | IIIF | IVF | IF | IIF | IIIF | IVF | 82A | 83F | 84F |
| Gross National Product | 2.6 | 9.2 | 7.6 | 3.8 | 3.8 | 4.1 | 4.5 | 3.6 | –1.9 | 3.2 | 4.7 |
| Personal Consumption Expenditures | 2.9 | 9.7 | 6.2 | 5.0 | 3.0 | 3.0 | 3.0 | 3.1 | 1.4 | 4.6 | 4.2 |
| Durable Goods | 7.5 | 32.1 | 17.4 | 16.6 | 6.1 | 5.5 | 5.2 | 5.1 | –.9 | 13.3 | 10.4 |
| Nondurable Goods | 3.2 | 5.9 | 4.3 | 2.5 | 2.2 | 2.3 | 2.3 | 2.2 | .5 | 3.1 | 2.8 |
| Services | 1.4 | 6.4 | 4.2 | 3.2 | 2.5 | 2.7 | 2.8 | 3.0 | 2.9 | 3.2 | 3.2 |
| Gross Private Domestic Investment | 28.7 | 50.9 | 29.6 | 2.6 | 7.6 | 8.5 | 10.1 | 8.3 | –14.5 | 9.4 | 11.8 |
| Fixed Investment | 8.8 | 19.2 | 12.3 | –3.5 | 3.8 | 6.2 | 8.1 | 7.3 | –6.9 | 5.4 | 5.5 |
| Nonresidential | –1.5 | 5.9 | 10.8 | 4.9 | 7.2 | 6.4 | 5.9 | 5.7 | –4.7 | –1.1 | 6.7 |
| Producers' Durable Equipment | 4.9 | 16.6 | 17.2 | 6.1 | 8.3 | 7.4 | 6.8 | 6.3 | –7.5 | 2.5 | 8.9 |
| Structures | –13.8 | –15.0 | –3.4 | 2.0 | 4.4 | 3.8 | 3.7 | 4.2 | 1.8 | –8.8 | 1.4 |
| Residential | 57.7 | 75.9 | 17.1 | –26.0 | –6.7 | 5.4 | 15.8 | 12.9 | –15.3 | 34.2 | 1.5 |
| Change in Business Inventories ($) | –15.4 | –4.0 | 3.8 | 7.2 | 9.3 | 10.7 | 12.0 | 12.8 | –9.4 | –2.1 | 11.2 |
| Government Purchases | –8.6 | –1.4 | .4 | 1.3 | 3.3 | 5.0 | 5.5 | 2.0 | 1.8 | .3 | 2.8 |
| Federal | –17.9 | –2.7 | 1.0 | 4.1 | 7.6 | 10.9 | 11.3 | 3.5 | 5.6 | 1.5 | 6.2 |
| State and Local | –1.6 | –.5 | 0.0 | –.5 | .5 | 1.0 | 1.5 | 1.0 | –.5 | –.5 | .4 |
| Net Exports ($) | 20.5 | 11.0 | 9.4 | 9.0 | 9.3 | 9.0 | 9.0 | 9.1 | 28.9 | 12.5 | 9.1 |
| Exports | 2.4 | –8.2 | 3.0 | 3.5 | 5.2 | 4.0 | 5.6 | 5.0 | –7.8 | –7.7 | 3.5 |
| Imports | 12.1 | 24.6 | 8.7 | 5.2 | 4.5 | 5.1 | 6.0 | 5.2 | 1.4 | 4.3 | 6.6 |
| Final Sales | .6 | 5.9 | 5.4 | 2.9 | 3.2 | 3.7 | 4.2 | 3.5 | –.7 | 2.7 | 3.8 |

A = Actual F = Forecast P = Preliminary

For the third quarter of 1983, the nation's civilian unemployment rate is expected to drop to 9.4 percent, and should decline to 9.1 percent in the fourth quarter. Strong employment growth together with a slower labor force expansion is placing much downward pressure on the unemployment rate. By the end of 1984, the civilian unemployment rate will reach 8.3 percent. Total nonagricultural employment will grow to a total of 101.3 million workers in the third quarter of 1983 as compared to the recession low of 99.1 million workers in the fourth quarter of 1982. By the end of 1984, employment will reach 104 million, representing a 1.1 percent annual increase in 1983, and 2.7 percent gain in 1984.

Employment of the goods-producing sector will continue to expand. The recent surge in auto sales produced much optimism in Detroit, resulting in healthy employment gains related to increased production of autos and other related goods. The long-awaited recovery which began at the end of 1982 finally grew into full strength in 1983. Consumer spending and industrial demand rose sharply for the first half of 1983. Factory production also increased and employment conditions began to improve. By June, total employment had reached 100.8 million, about the same level as the peak in the summer of 1981. During June, total nonagricultural employment rose an impressive 1.2 million, followed by a robust 0.5 million increase in July, resulting in an annualized gain of 2.8 percent between the first and second quarters of 1983.

Even more encouraging, the recent employment statistics showed rapid climbs in the manufacturing and construction industries, the two hardest hit industries during the recession. There were sharp increases within the retail trade category. This exceptionally fast growth in employment during June and July reflected employers' need to rebuild their depleted payrolls. The robust recovery will keep the trade and service employment on a strong growth trend, while construction employment is more susceptible to volatile mortgage rates. Budgetary concerns will keep government employment expanding at a more modest rate than the rest of the economy despite higher receipts in the next few quarters.

On a regional basis, the Northeastern and Northwestern regions will revive strongly from their depressed condition and should report the biggest gains in employment. Unemployment will improve across all major demographic groups except for teenage workers, whose relative lack of skills makes it difficult for them to compete for jobs.

## THE OUTLOOK FOR BUSINESS INVESTMENT

Business capital spending was a major casualty of the 1981-1982 recession. Non-residential capital investment, which advanced at a 9 percent annual rate in the first three quarters of 1981, declined nearly 10 percent from the fourth quarter of 1981 through the first quarter of 1983. However, during the same six-quarter period, real GNP declined less than 2.5 percent. Although capital investment is typically more sensitive to business cycle changes than the rest of the economy, this weakness cannot be completely attributed to the recent economic downturn.

Since the 1960s, the growth rate of busines fixed investment has fallen substantially. An examination of the data shows that the share of real output devoted to nonresidential investment has declined by more than 30 percent between the 1960s and 1970s. Moreover, the growth rate of the nonresidential capital stock recorded an even greater decline, falling aproximately 40 percent during the same period.

Security Pacific Bank's research shows that the general decline in capital investment in the U.S. can be partially traced to the significant increase in the inflation rate and its interaction with the tax code.

These factors distort substantially the after-tax real rate of return on investment, and reduce the attractiveness of nonresidential business spending relative to other forms of investment.

The interactive effect of inflation and the existing tax structure distort the relative return to nonresidential capital in two important ways. First, an increase in the rate of inflation lowers the real value of depreciation costs. This is an especially significant and persistent problem for capital intensive industries, such as autos and heavy equipment. Secondly, common stock shareholders pay capital gains tax on nominal increases in the value of their stock. Thus, even if stock prices increase just at the rate of inflation, individuals will be taxed as if their gains were real rather than purely nominal. Both of these effects tend to depress firms' market value, and lower their ability to compete effectively in financial markets.

In addition to these long-run factors, recent investment activity also reflects the severity of the latest recession. Deterioration in capital spending is partially a result of weak demand for manufactured goods, excess industrial capacity, high real interest rates, and the poor health of corporate balance sheets.

## REAL CAPITAL SPENDING OUTLOOK
**(Percent Change)**

| | 1983 | | | | 1984 | | | | Years | |
|---|---|---|---|---|---|---|---|---|---|---|
| | IA | IIA | IIIF | IVF | IF | IIF | IIIF | IVF | 83F | 84F |
| Fixed Investment | 8.8 | 19.2 | 12.3 | -3.5 | 3.8 | 6.2 | 8.1 | 7.3 | 5.4 | 5.5 |
| Nonresidential | -1.5 | 5.9 | 10.8 | 4.9 | 7.2 | 6.4 | 5.9 | 5.7 | -1.1 | 6.7 |
| Durable Equipment | 4.9 | 16.6 | 17.2 | 6.1 | 8.3 | 7.4 | 6.8 | 6.3 | 2.5 | 8.9 |
| Structures | -13.8 | -15.0 | -3.4 | 2.0 | 4.4 | 3.8 | 3.7 | 4.2 | -8.8 | 1.4 |
| Residential | 57.7 | 75.9 | 17.1 | -26.0 | -6.7 | 5.4 | 15.8 | 12.9 | 34.2 | 1.5 |

Weak final demand has had the important effect of decreasing manufacturers' output. From mid-1981 to the end of 1982, industrial production and capacity utilization declined approximately 12 percent. These data tend to suggest that the demand for investment has declined because firms can expand output significantly with their current capital stock.

High real interest rates, which may be defined as the nominal interest rate less the expected rate of inflation, have also had a substantial impact on capital spending. Increases in the real rate of interest depress investment by effectively raising the cost of capital expansion. Moreover, the interaction of high lending rates with excess industrial capacity has created an environment which encourages firms to conserve cash and purchase high-yielding securities, rather than commit funds to long-term capital projects. High rates also led to a deterioration in corporate balance sheets. Since the fourth quarter of 1979, persistently high long- and short-term rates have resulted in debt service requirements rising to record levels. This burden consumes a significant amount of firms' resources and limits their ability to expand.

Despite these negative factors, recent evidence indicates that the cyclical slide in capital spending is over. Nonresidential fixed investment, which declined 1.5 percent in the first quarter of 1983, increased a healthy 6.1 percent in the second quarter. This turnaround reflects a reduction in expected inflation, the robust expansion in domestic final demand, and the long-term benefits of the recent change in tax legislation. Security Pacific Bank estimates that real fixed investment will increase 5.4 percent in 1983, and 5.5 percent in 1984.

Nonresidential investment is expected to advance 0.4 percent this year, and 10.7 percent in 1984. The increase in durable equipment spending reflects improving corporate profits and balance sheets, as well as the cyclical strength of the economic expansion. Investment in nonresidential structures remains relatively weak over the forecast period, as a result of the significant surplus of office space in many urban areas.

As a result of the dramatic growth in housing starts, residential investment has been particularly robust, advancing at nearly a 60 percent annual rate from the end of 1982 through the first two quarters of 1983. However, these growth rates are typical of the initial phase of an economic recovery, and cannot be expected to persist. Residential spending is projected to decline in the last two quarters of 1983 and the first quarter of 1984, partially reflecting higher lending rates. Fairly robust growth should resume over the balance of 1984, reflecting favorable demographic trends in housing demand, as well as rising real income.

Many of the factors which fundamentally determine the demand for investment have already begun to improve. Oil prices declined markedly over the past year, and seem to be exhibiting additional weakness. A decline in the price of energy stimulates investment spending since it reduces the cost of operating capital equipment. Although the full effect of lower crude prices will tend to be distributed over time, it should provide a significant positive contribution to investment over the forecast interval.

Industrial production and capacity utilization recorded substantial gains during the first two quarters of 1983. These data help form business expectations about future levels of demand, and future capacity re-

quirements. Moreover, the rapid rise in stock prices over the last few months has increased significantly the market value of publicly held firms. This trend has led to a substantial increase in new offerings of common stock, which provide additional funds for capital spending. Although interest rates have declined markedly, they still are high relative to the current rate of inflation. Moreover, we do not expect any dramatic change in real interest over the next year. However, the most recent data suggest that the determinants of investment are positive, on balance, and should provide sufficient stimulus for a significant gain in capital spending through 1984.

## CORPORATE PROFITS

Corporate profits are projected to show substantial improvement in 1983 and 1984 relative to the performance of the past several years. For nonfinancial corporations, profit gains will reflect the combined effect of increasing ouput levels and widening profit margins. Meanwhile, a lower level of interest rates than that seen over the past several years, in concert with continuing expansion in housing activity, will result in a return to profitability of the thrift industry. As a result, profits of financial corporations will also exhibit sizeable gains. Finally, net foreign profits are expected to rise in conjunction with economic recovery and expansion in other countries.

The projected change in before-tax profits will actually understate the improvement in the financial well-being of corporations. The accelerated depreciation measures, allowed under the 1980 Economic Recovery and Tax Act, have already provided for a substantial increase in the depreciation expenses and a reduction in before-tax profits. In 1980, the under-depreciation of capital led to an overstatement of before-tax profits of $16.9 billion, or 6.9 percent of before-tax profits. In 1982, this under-depreciation had dropped to $1.1 billion, less than 1.0 percent of before-tax profits. In 1983 and 1984, before-tax profits should be understated by $24.6 billion and $34.5 billion, respectively. This effect will be offset partially as inventory profits, or profits resulting from the understatement of cost-of-goods sold, rise in 1984. Nevertheless the before-tax profits concept does not provide a particularly meaningful basis for discussion. Operating profits, or profits from current production, exclude the effects of both of these adjustments and provide a better indication of profitability between periods.

From $197.6 billion in the third quarter of 1981, operating profits fell to $161.9 billion in the fourth quarter of last year. Operating profits of nonfinancial corporations exhibited an even more dramatic decline over the same period, falling from $158.8 billion to $114.3 billion. This decline in profitability was attributable to a decline in output and a decline in profits per unit. Although the nonfinancial sector is subject to greater cyclical swings than the economy in general, it was particularly hard hit in the recent recession. The peak-to-trough decline in real output in the nonfinancial sector was almost double that for the economy as a whole. In contrast, the decline of nonfinancial corporate output during the 1974 recession was only 25 percent greater than the decline in real GNP. The recent cyclical decline in unit profits resulted as both unit labor and unit nonlabor costs rose more rapidly than output prices. In the third quarter of 1983, profits accounted for 8.9 percent of sales, while labor costs accounted for 66.7 percent and nonlabor costs, 15.1 percent. Comparatively by the end of 1982, the profit share had dropped to 6.4 percent while labor's share had risen to 67.7 percent, and that of other costs to 25.8 percent.

Through the first half of 1983, nonfinancial corporations have enjoyed a substantial rise in operating profits with increases in both output and profit margins. The rise in unit labor costs has dropped from an annual rate of increase of almost 12 percent in the fourth quarter of 1981 to less than 3 percent. While a portion of this improvement is attributable to a slowing in labor compensation rates, most of the improvement reflects the effect of improved productivity beginning in the second half of 1982. This improvement in productivity was all the more striking in that it was achieved during a period of declining output. In addition to slowing in absolute terms, the increase in unit labor costs has slowed relative to the rise in product prices, as has the rate of increase in nonlabor unit costs. As result, profits in the second quarter accounted for the largest share of sales since the third quarter of 1981.

Operating profits of nonfinancial corporations are expected to continue to rise through 1984, although at a slower pace than that of the past two quarters. From the second quarter of 1983 through the end of 1984, output is expected to increase by some 10 percent while profit margins are expected to increase some 35 percent. The widening profit margins should occur as both unit labor and unit nonlabor costs rise at a slower rate than unit prices. The increase in labor compensation rates is expected to accelerate as the recovery continues. This acceleration will be particularly apparent in those

## CORPORATE PROFITS OUTLOOK

| | $ Billions | | | Percentage Changes | | |
|---|---|---|---|---|---|---|
| | 1982A | 1983F | 1984F | 1982 | 1983 | 1984 |
| Operating Profits | 164.8 | 227.0 | 291.6 | -14.3 | 37.8 | 28.4 |
| Capital Consumption Adjustment | -1.1 | 24.6 | 34.5 | — | — | — |
| Inventory Valuation Adjustment | -8.3 | -8.6 | -19.9 | — | — | — |
| Corporate Profits Before Taxes | 174.2 | 211.0 | 277.0 | -23.2 | 21.2 | 31.2 |
| Corporate Profits After Taxes | 115.1 | 133.4 | 175.0 | -20.2 | 15.5 | 31.6 |
| Book Depreciation | 220.9 | 257.6 | 289.6 | 15.1 | 16.6 | 12.4 |
| Gross Cash Flow | 336.0 | 391.0 | 464.6 | 0.0 | 16.4 | 21.6 |
| Dividends | 68.7 | 74.1 | 81.0 | 6.2 | 7.9 | 9.3 |
| Cash Flow Less Dividends | 267.3 | 316.9 | 383.1 | — | — | — |
| Operating Profits / GNP | 5.4% | 6.9% | 8.0% | — | — | — |
| Before Tax Profits / GNP | 5.7% | 6.4% | 7.6% | — | — | — |
| Nonfinancial Corporations | | | | | | |
| Compensation per Hour | — | — | — | 7.9 | 5.3 | 7.2 |
| Productivity | — | — | — | 0.5 | 3.4 | 3.3 |
| Unit Labor Cost | — | — | — | 7.3 | 1.9 | 3.7 |

industries in which labor accepted wage reductions or freezes during the recession. Also, compensation rates will reflect the increases in the Social Security tax rate and taxable wage base, scheduled for January 1, 1984. With an anticipated slowing in productivity gains, unit labor costs will also accelerate. Nevertheless, the projected increase in unit labor costs for 1983 and 1984 would be the lowest since 1972. The increase in unit nonlabor costs should slow relative to prices as corporations continue to restructure balance sheet ratios and reduce net interest expense and as depreciation expense is allocated over more output.

An increase in profits of financial corporations will largely be attributable to the return to profitability of the thrift industry. Since the second quarter of last year, most of the some $13.0 billion gain in profits of financial corporations was in fact accounted for by savings and loan institutions. This gain reflected the decline in interest rates and the increase in construction activity. As a result, the Federal Reserve Bank's share of all financial corporations' profits has fallen from 78 percent in the second quarter of last year to some 43 percent one year later.

## THE OUTLOOK FOR INFLATION

One of the most important and surprising economic developments of the last two years has been the substantial decline in the nation's rate of inflation. Although many economists had predicted modestly lower inflation for 1982 and 1983, very few anticipated the dramatic deceleration which has occurred.

Although the administration's goal of long-term price stability remains elusive, significant inroads have been made. Progress against inflation becomes quite evident when one examines the changes that have been taken place in the major price indexes. The Consumer Price Index, which rose 13.5 percent in 1980, and 10.3 percent in 1981, advanced 6.2 percent in 1982. The Producer Price Index gained just 4.0 percent in 1982, after increasing 14.1 percent in 1980 and 9.7 percent in 1981. The GNP price deflator, which is generally considered to be the most representative measure of inflation, recorded a similar performance. The deflator increased a moderate 5.9 percent in 1982, after rising 9.0 percent in 1980 and 9.4 percent in 1981.

The trend of lower inflation has continued into 1983 as well. Between December 1982 and July 1983, the Producer Price Index declined 0.4 percent, while the Consumer Price Index advanced a modest 1.4 percent. Although these data largely reflect declining oil prices, it should be noted that the prices of other goods, particularly food and capital equipment, have shown little strength.

These developments are important for two primary reasons. First, lower inflation generally leads to more efficient economic performance. Distortions in rates of return on capital investment (which are caused by the interaction of the tax code and rising inflation) are minimized, and economic uncertainty is typically reduced. Secondly, the most recent evidence suggests that inflation can be reduced quickly given the appropriate policies. Prior to 1981, it was the opinion of many economists that only several years of economic reform and sluggish growth could purge inflation from the U.S. system. Current developments reject decisively this point of view.

A good deal of historical evidence suggests that the equilibrium rate of inflation is determined principally by the long-run growth of the money stock. Moreover, it has been shown that the response of the price level to changes in the growth rate of money occurs with a significant lag. From a long-run outlook, this lag indicates that the current rate of inflation reflects the monetary restraint of 1981 and early 1982. From a short-run viewpoint, inflation also reflects significant changes in key relative prices. Security Pacific Bank's research indicates that a good deal of the high inflation of the late 1970s and early 1980s can be explained by sharp increases in the prices of food, energy, and housing.

Between 1979 and 1981, crude oil prices rose from $12.00 per barrel to $34.00 per barrel. This episode of sharply higher energy prices was a result primarily of reduced oil supplies from the Middle East, reflecting political and military events in Iran and Iraq. Food prices also advanced rapidly during this period, as a result of both poor harvests and federal agricultural policy that was designed to support basic farm prices. Housing prices, which were fueled by lower real interest rates and increased demand for housing, rose 134 percent between 1972 and 1980.

The same factors which helped produce the most recent period of double digit inflation are now pushing the rate of inflation lower. The single most important factor over the last two years has been energy prices. Facing a global petroleum surplus. OPEC reduced the marker price of oil from $34.00 per barrel to $29.00 per barrel. It is interesting to note that this price cut took place despite a 50 percent decrease in OPEC crude production. This fact indicates clearly that OPEC's influence on the world economy has significantly weakened.

Food price increases have slowed dramatically, reflecting record harvests and the economic downturn. After rising nearly 8.5 percent in 1980, the processed foods component of the Producer Price Index advanced just 1.1 percent in 1982.

Housing prices recorded their smallest gain in over a decade, rising less than one percent, as high real interest rates helped to push prospective buyers out of the market.

Although we do not anticipate that these prices will continue to perform in this fashion, the rate of inflation should remain moderate throughout 1984. Security Pacific Bank estimates that prices as measured by the GNP deflator, will rise 4.5 percent in 1983, and 5.2 percent during 1984.

The bright news on prices should continue to come from the energy sector. Gasoline and fuel oil prices rose modestly during the summer as a result of inventory rebuilding. However, there has been little change in the basic market for crude oil, and the most recent data indicate a weakening of prices. This has resulted in gasoline prices declining 2 to 3 cents per gallon, and further decreases would not be surprising. The refined petroleum products component of the Producer Price Index is expected to decline 10 percent in 1983, and should be flat during 1984.

Wage gains should continue to be moderate over the forecast period. During the six months, ending in July 1983, the hourly wage index increased a modest 4.5 percent, compared with 6 percent in the preceding six months. Recent wage settlements in the copper and aluminum industries call for labor costs increasing less than 4 percent annually over the next three years. Similar settlements have occurred in the lumber and paper industries, with wage rates rising between 4 and 6 percent through 1986. Total compensation costs, which advanced 7.3 percent in 1982, are expected to rise 5.6 percent in 1983 and 5.8 percent in 1984.

On balance, food price increases should remain modest over 1983, reflecting large surpluses of key commodities. However, the drought which has affected the midwest, combined with the government's payment-in-kind (PIK) program, will substantially reduce corn yields, and ultimately push prices higher. Feed-

## INFLATION OUTLOOK
**(Percent Change)**

| | 1983 | | | | 1984 | | | | Years | |
|---|---|---|---|---|---|---|---|---|---|---|
| | IA | IIA | IIIF | IVF | IF | IIF | IIIF | IVF | 83F | 84F |
| GNP Price Deflator | 5.5 | 3.5 | 4.7 | 5.1 | 5.5 | 5.2 | 5.8 | 6.2 | 4.5 | 5.2 |
| Consumer Price Index | –0.4 | 4.2 | 4.8 | 5.0 | 5.1 | 5.3 | 5.5 | 5.5 | 3.3 | 5.1 |
| Producer Price Index | –2.6 | 0.7 | 4.6 | 4.9 | 5.1 | 5.4 | 5.5 | 5.6 | 2.0 | 4.8 |

grain prices have already begun to increase, prompting cattle producers to dump current stocks on the market. At current prices for corn and livestock, producers are better off selling current supplies, rather than keeping them in feedlots. The net effect of this behavior depresses cattle prices, thus lowering current food costs. However, herds should be quite thin next summer, suggesting that beef prices in 1984 may increase substantially. The food and beverage component of the Consumer Price Index is expected to increase 3.6 percent in 1983, and 6.1 percent in 1984.

There has already been a substantial downward influence on price increases resulting from cyclical gains in productivity. Moreover, productivity growth (which is discussed at greater length in another section of this report) will be a positive force for dampening inflation as well as for encouraging real economic activity through 1984. The expected longer-term productivity increase reflects primarily the "baby boom" cohort entering a more productive stage in its career cycle and continued technological advancement in the capital stock.

Recently, some economists have expressed concern over the rapid increase in the money supply during the past year. Typically, increases of this magnitude are associated with higher inflation. However, much of the growth in money is a result of the substantial innovations which are taking place in the newly deregulated financial services industry. Although we are not completely discounting the possible inflationary effects of the current monetary expansion, we consider the prospect of "too much money chasing too few goods" to be unlikely, at least in the near term.

## INTERNATIONAL TRADE DEVELOPMENTS

U.S. export growth was extremely modest during 1983. This weakness, combined with an accelerating increase in imports, will pull real net exports for 1983 down to $12.5 billion, compared with $28.9 billion during 1982. During 1984 a continuation of these trends is projected to reduce the inflation-adjusted net export figure for the year to $9.2 billion.

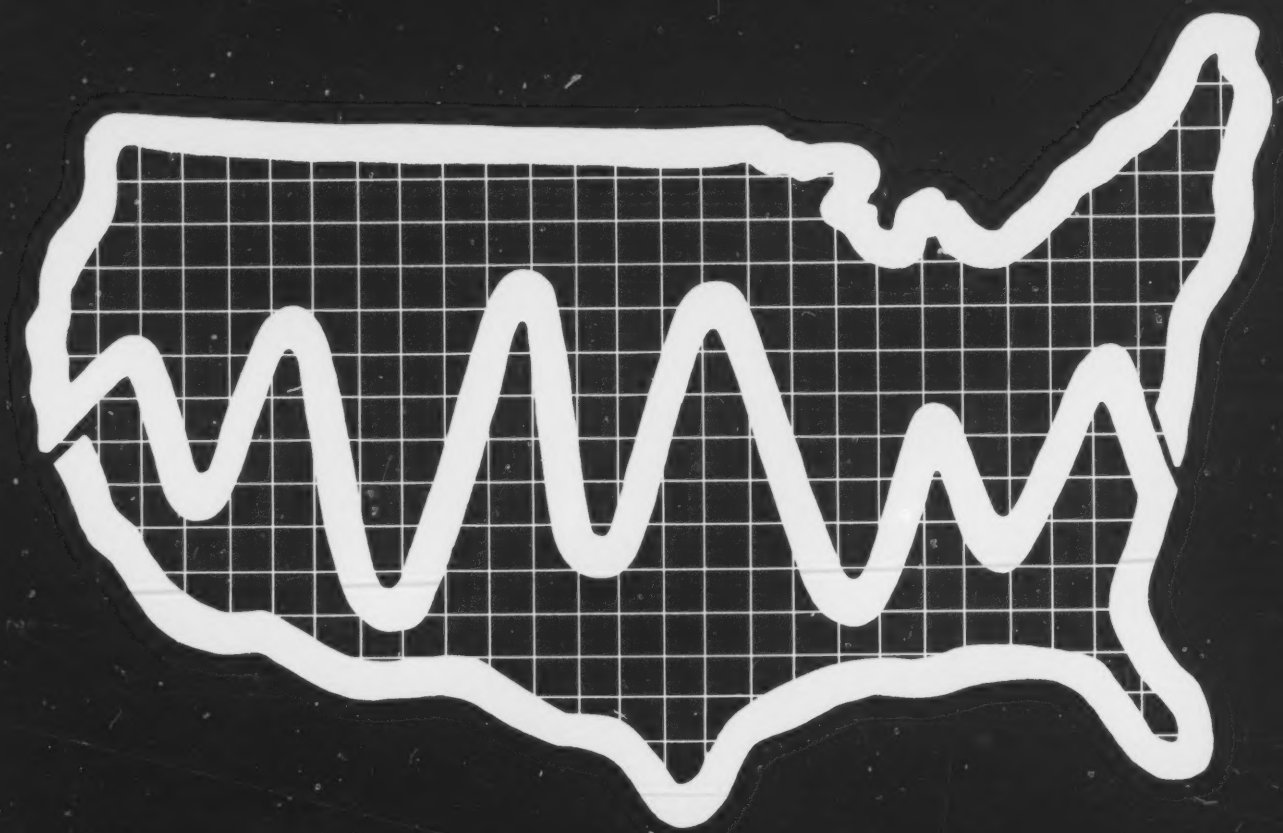
The dissipation of the trade situation is based on a U.S.-led industrial recovery which is pulling in imports while export growth awaits a lagged trading partner recovery. Additionally, the strong dollar has reinforced these trends producing a rapid deterioration in the U.S. trade and current account positions. The current account moved from an $8 billion deficit in 1982 to an estimated $30 billion deficit in 1983, followed by a projected $37 billion deficit in 1984.

Although the deterioration in the trade and current account positions has been dramatic, it has not produced what some experts have anticipated — a rapid decline in the value of the dollar. The dollar's strength is due to the strong capital inflows which have, on the short-term, come from our relatively high interest rates, and on the long-term side, from the safe-haven view of U.S. economic and political stability. Given our interest rate assumptions of no significant drop in rates, and also assuming the continuation of political disturbances in the Middle East, Central America and Eastern Europe — which underpin the safe-haven view — we anticipate that the dollar will not drop drastically in value, although it is expected to erode through 1984. The decline in the dollar will not be great enough to aid significantly the nation's trade position. Nonetheless, as other countries move more in phase with the U.S. economy as we move through 1984, the trade picture should begin to show some modest improvement.■

# ECONOMIC REPORT

SPRING-SUMMER 1984

## LONG-TERM U.S. OUTLOOK EDITION



SECURITY PACIFIC NATIONAL BANK

# SPRING-SUMMER 1984

**Number 71**

**This report highlights the long-term outlook of the United States economy through 1989.**

**Subsequent issues of the ECONOMIC REPORT will discuss the following topics:**

**Short-term U.S. and California Outlooks, Fall 1984.**

**International Edition, Winter 1984.**

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# SUMMARY

This report summarizes our 5-year outlook for the United States economy. Following a strong economic recovery that produced real GNP growth of 8.3 percent from the fourth quarter of 1982 through the first quarter of 1983, the economy is expected to slow in late 1984 and 1985. Although this study does not attempt to predict the timing of the next recession, in our view the peak levels of inflation and interest rates after 1985 are likely to be well below those of 1980 and 1981, allowing the economy to follow a sustainable growth path at an inflation rate that most people would find acceptable.

The responsible conduct of fiscal and monetary policies, especially between now and the end of 1985, is also a key to the attainment of this growth path. Although the federal budget deficit is projected to remain at a high dollar level through 1989, it should decline significantly as a percent of GNP due to likely legislative action during the next two years. That improvement in fiscal management is expected to be balanced on the monetary side by continued management of the monetary and credit aggregates with a view to containing inflationary pressures. We acknowledge, however, that balance between these forces will be difficult to maintain, with the result that financial markets will continue to display a high degree of short-term volatility.

The trend rate of real GNP growth from 1983 to 1989 is projected to be 3.4 percent per year. The trend rate of inflation, as measured by the GNP deflator, is expected to be 6.1 percent per year, although the peak rate could be in the 8-to-9 percent range. As a result of the inflation and real growth trends, current-dollar GNP should increase at a compound annual rate of 9.6 percent from 1983 to 1989. Among the components of real GNP, the fastest growth will be recorded by producers' durable equipment, largely on account of the high short-term growth rates projected for that category in 1984 and 1985. Consumer spending for durable goods and federal defense spending should also exceed the trend rate of growth by a wide margin. A declining share of output will be taken by consumer spending for nondurable goods and services, nondefense federal purchases, and state and local government.

The 1989 economy will combine resources more efficiently than in 1983. Continued deregulation combined with technological advance will result in lower production costs, in real terms, for many industries. The gradual aging of the population will produce a more experienced and productive labor force. Although capital spending is expected to slow in 1986 and beyond, private investment spending during the 1983-1989 period should be sufficient to renew a large portion of the nation's plant and equipment.

Although we do not expect interest rates to remain stable during the next five years, they should be less volatile than during the 1979-1982 period when the Federal Reserve Board was tightly targeting the money supply. The 5-year average levels of short-term rates should be close to the expected 1984 levels, although rates are likely to reach peaks during the next several years that are above current readings, while well below the peak readings of 1980-1981.

The final section of this report reviews industry growth trends for a broad range of industry categories and compares projected production for the 1983-1989 period with recent performance for those industries. Major sectors of the economy are ranked according to high, medium, or low growth prospects. Leading the high-growth category are the nonelectrical machinery and rubber and plastics sectors, both of which are expected to realize average production gains of more than 7 percent per year from 1985 to 1989. ■

# 1984–1989: POLICY OVERVIEW

In an economic system as complicated as that of the U.S., it is not possible to chart with precision the timing or magnitude of the factors that will cause the business cycle swings that are inevitable during the next five years. Therefore, we concentrate on analyzing the trends that are most likely to matter to decision-makers in business, households, and government during this time frame.

In examining the basic determinants of longer-term economic growth, such as the labor force, capital spending, and productivity, we find it hard to agree with critics who see doom and gloom ahead for the economy. In our view, the economy is now more resilient that it has been for a long time due to significant structural change that has occurred during the last several years. There are several significant aspects to this restructuring.

Removal and simplification of complex regulatory structures in major sectors of the economy will enable American businesses to function more efficiently. Deregulation in the financial services industry will benefit American industry by making capital flows more efficient and is benefiting consumers by giving them a market rate of return on savings balances. Although deregulation often has destabilizing effects that are costly in the short run (for example, marginal firms are likely to founder), the benefits to society in terms of more efficient resource allocation should ultimately far outweigh these "start-up" costs of deregulation. Barring an unexpected reversal of the present federal policy of reduced regulation of the economy, U.S. markets are likely to be even more competitive, and efficient, in 1989 than in 1983.

The determination of wage levels is also becoming increasingly influenced by competitive forces. This practice is already resulting in a more efficient cost structure in basic industries where wage gains far exceeded productivity growth in recent years, making it almost impossible for those industries to export effectively. And, for every group that was being rewarded in excess of its contribution to productivity, some other group (for example, investors in those industries) was being deprived, further starving those industries of much-needed capital investment for modernization. These trends are also promising for the next five years.

The nation's federal fiscal and monetary policies have also been coming more in line with economic reality. Although the federal budget deficit remains far higher than we would like to see it, the Congress now appears to have the will to accomplish a significant reduction in both the dollar amount and the percentage of output going to the deficit. The Federal Reserve Board has done an admirable job of wringing inflation from the economy during a period when its task was complicated severely by the deregulation of the financial services industry. We expect the Fed to maintain its vigilant attitude toward a possible resurgence of inflation, and accordingly we are projecting that the inflation rate will not exceed the high single-digit range even at its peak in the next five years.

In summary, we expect that policymakers in government will be kept acutely aware, by the voters if necessary, of the undesirability of returning to the inflationary excesses of the past. Their ability to manage through a period in which interest rates will remain at relatively high historic levels, and inflationary expectations will be at best subdued, will be strongly put to the test. On balance, however, we expect to see an emphasis on the maintenance of a policy mix that fosters sustainable economic growth and employment at an acceptable rate of inflation. ■

# DETERMINANTS OF LONG-TERM GROWTH

## THE U.S. ECONOMIC POTENTIAL

It is very useful to have a measure of potential economic performance which gives us a standard for comparison with the economy's actual performance. Probably the most popular such standard is the concept of potential GNP. Generally, the potential GNP is defined as that volume of goods and services (as measured by real GNP) that would be produced if all resources were fully employed. Due to problems in measuring and valuing the capital stock, the definition is usually abridged to the "full employment" of labor.

Generally speaking, full employment is understood to be the lowest rate of unemployment of the labor force attainable, under the existing economic structure, consistent with the absence of inflationary pressures. Historically, even at very high demand levels, some proportion of the work force is normally seeking initial jobs or between jobs, consistent with the changing skill requirements of industry and the shifting occupational and locational preferences of the labor force.

For much of the nation's post-World War II history, an unemployment rate of about four percent was considered to be the noninflationary full employment rate. That rate, however, is not a constant but depends on the changing composition of the labor force. Consequently, as the labor force has changed over time to include a larger proportion of groups with typically higher equilibrium rates of unemployment, the full employment rate of unemployment has also risen.

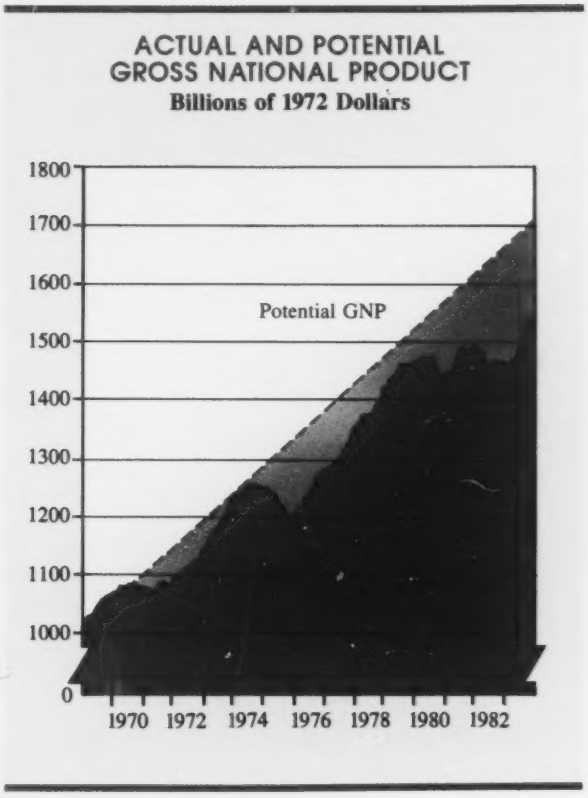
It is generally accepted that there have been three years in the postwar period when the economy operated near potential output. These years — 1955, 1965, and 1973 — usually are referred to as full employment years. To determine the full employment rate of unemployment for this and future years, one can use the unemployment rates by age and sex observed in past full employment years as a guide to apply to the actual and/or projected labor force composition. Based upon the current composition of the labor force, the full employment jobless rate is currently estimated at about 5 percent, rather than the 4 percent rate historically thought to be full employment. It should be noted, however, that many analysts consider 6 percent to be a more appropriate measure of full employment.

This increase is due primarily to the increased labor force participation of women of all ages and young people of both sexes which has occurred during the past two decades. During the next five years, a moderation of these trends, plus a gradual aging of the labor force, should lead to a slight reduction of the full employment rate of unemployment.

**FORECAST HIGHLIGHTS**
**(1983-1989)**

| Aggregate Demand | 1973 | 1983 | 1989 |
|---|---|---|---|
| Potential GNP (1972 $) | 1,258.3 | 1,711.4 | 2,001.1 |
| Real GNP (1972 $) | 1,254.3 | 1,535.3 | 1,872.5 |
| GNP Gap (%) | 0.3 | 10.3 | 6.4 |
| Unemployment Rate (%) | 4.9 | 9.6 | 6.8 |
| Nominal GNP (current $) | 1,326.4 | 3,310.8 | 5,776.1 |

| Growth Trends | 1973-83 | 1983-89 |
|---|---|---|
| Real GNP | 2.0 | 3.4 |
| Inflation | 7.4 | 6.1 |
| Nominal GNP | 9.6 | 9.7 |
| Hours per Worker | –0.5 | –0.4 |
| Labor Force | 2.2 | 1.7 |
| Productivity | 0.8 | 1.6 |
| Compensation per Hour | 8.6 | 7.7 |




The concept of the full employment gap is illustrated in the chart accompanying this text. When potential GNP is greater than actual GNP, as it has been continuously since 1973, the difference between the two curves is a measure of the gap that must be closed by growth in real output in order to attain full employment, or economic potential. For 1983, when unemployment averaged 9.6 percent, the GNP gap was 10.2 percent. Growth in potential GNP averaged 3.3 percent from 1973, the last full employment year, to 1983. Actual GNP growth, however, fell far short of that measure, increasing just 2.0 percent per year as the economy experienced three recessions during the 10-year period.

Potential GNP growth is projected to slow considerably during the remainder of the 1980s. From 1983 to 1989, the nation's potential output is likely to expand at a 2.6 percent compound annual rate, which is considerably less than the projected 3.4 percent annual growth in actual GNP over the same period. This projected differential between actual and potential GNP growth would result in a reduction of the GNP gap to 6.0 percent in 1989 and would lower the civilian unemployment rate to 6.8 percent. The primary reason for the lowering of potential GNP growth over the next decade is the expected slowing of labor force growth over that period. The changes in long-term population and labor force participation trends that are expected to result in a lower potential GNP growth path are discussed in the following section of this report.

## POPULATION

In 1983, the U.S. population reached 235.2 million, slightly higher than the official Census Bureau projection. We expect the population to grow at an average annual rate of 0.9 percent, and reach 246 million in 1989. By the end of this decade, there will be 18 percent fewer teenagers than there were in 1980. The elderly population comprising the 55 and older age group should increase by over 11 percent. More and more baby boomers will turn middle aged by 1990. The minority population, especially the Hispanics, will be the fastest growing group in the nation. In Hispanic-populated states like California, about one out of four newborns in 1980 were of Hispanic-American origin.

According to the most recent fertility report from the Bureau of Census, 7 percent of married women age 18 to 34 say they do not plan to have children. In contrast, only 2 percent of young wives expected to be childless in 1967. In 1980, 19 percent of young women with an advanced degree or a professional job expected to remain childless. Despite lower fertility rates, the birth rate has risen steadily since 1975 and is now almost equal to its level during the peak baby boom years. Nearly three and a half million women had babies between June 1981 and 1982. As the huge group of "baby boom" women approached the end of their child-bearing ages, necessity forced them to begin to raise a family at that time, if they ever wanted one. Consequently, we shall see a surging demand for child care facilities and educational services in the coming years.

The consumption potential of the baby boomers, a group that holds over 30 percent of the current U.S. population, has always been a matter of concern for marketing strategists. The rise of a more committed and well-paid female work force has further changed the consumption pattern of many single- and dual-income

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households. Demographers have applied new terms like the "yuppies" — young urban professionals — to describe this group of consumers. Cutting across sex, race, and career orientation, this cohort of young, educated, and well-paid middle class individuals or households possessed a more sophisticated and affluent taste for goods and products than their predecessors. It is estimated that by 1995, households earning $35,000 or more (in 1980 dollars) will grow faster than any other income bracket in the country.

In 1980, 21 of the nation's 50 largest metropolitan areas were located in the Northeast or North Central regions. California had a state population of 23.7 million, while Alaska had only 402,000 residents. The National Planning Association provides a population projection which takes both the economic and demographic factors into account. This model projects smaller losses for the industrial north than the Census Bureau's forecast. According to NPA, "water availability in the Mountain States will be a long-term impediment to rapid growth. And the resurgence of economic activity in the Northeast and Midwest will offer less migration to the Sunbelt." Only five states — namely Arizona, Wyoming, Utah, Nevada, and Alaska — will experience a population growth of over 20 percent in the eighties.

## LABOR FORCE AND EMPLOYMENT OUTLOOK

In 1970, the median age of the U.S. labor force was 39, but by 1982, the median age had dropped to 35 reflecting the influx and absorption of the "baby-boom generation" into the labor force. Technical advancements and demographic changes in the last few decades had brought new dimensions to the nation's labor market. In fact, the market had grown to be so complex that the government abolished the terms "blue-collar" and "white collar" for job classifications. A new set of classifications which showed a more precise definition of job nature such as professional/technical, craft and kindred, etc. was used instead.

In 1940, four major categories, namely white collar, blue collar, service, and farm workers, were used in the federal government job classifications. Blue collar workers represented 40 percent of the work force. By 1982, white collar occupations accounted for 52 percent of all jobs. In the last two decades, professional and technical occupations, which could be found in a traditional blue collar industry like manufacturing or in a typical white collar industry such as financial institutions, had expanded by 131 percent. It would thus be more meaningful to distinguish the workers by their skill level than by the old classifications.

The prime age-group of labor force members in the 80s consisted of the cohort that was born between 1947 and 1962; they were the "baby boomers." Due to their massive number, the baby boom generation had left marked changes on the society as they grew up and matured in the past few decades. The relatively stable and prosperous American economy in the last thirty years had produced a cohort of young and more educated workers. Fully one in five workers in 1983 was a college graduate compared to one in eight in 1970. Women represent 40 percent of the labor force. In fact, over two-thirds of the women in the 20-to-45 age group are working or actively looking for work. Unlike their predecessors who were more confined to the traditional "pink collar" or service type of occupations, these younger women participate in a broader gamut of careers.

The female labor force participation rate has grown at an uninterruped pace since the mid-1940s, though with a slowdown in 1983. However, data from 1984 suggest that the 1983 slowdown was more a "discouraged worker" effect caused by the latest recession than a signal of a new trend. On the one hand, families headed by women, which have risen dramatically, are more vulnerable to poverty. On the other hand, the emergence of more career women raises the potential income of many households.

Between 1972 and 1982, employment rose in ten of the twelve major industry groups. Agriculture, forestry, fishing, and private household services were the only groups that reported a decline in employment. During those ten years, mining employment increased by 72 percent. The manufacturing group, which accounted for 24.3 percent of total employment in 1972, fell to 20.4 percent in 1982, but the share rebounded to 21.1 percent in the first quarter of 1984. Changing technology has reshaped the structure of the American work force. The rapid pace of development in computer research has made the automation technology more economical and accessible to the public. Increasing usage of computers and telecommunications will bring more permanent changes in the market demand for workers' skills. Service industries with high-tech applications will take up a larger share of the job market, while other major employment categories like manufacturing will constitute a lesser portion of the labor force.

The 1981-82 recession hurt U.S. laborers tremendously, as more than one fifth of the American work force experienced some unemployment during 1982. Around 42 percent of the 2.1 million workers who were terminated during the recession were under age 25. Many of them were new entrants to the labor force. Affected workers were found proportionately highest in the East North Central states. Disparities by occupation were even greater. The managerial and professional workers had lost only 1.6 percent of their normal share of income to this recession. However, the production line workers and laborers gave up nearly nine percent of their share of earnings. In 1982, unemployment insurance payments rose $12 billion, although only one third of the unemployed in that year were covered by the benefit program.

The stronger-than-expected recovery beginning in 1983 is providing much hope and reassurance. The nation's unemployment rate dropped almost three percentage points from its peak in November 1982 to April 1984. Employment rose strongly in hard-hit industries like manufacturing and construction. The number of discouraged workers fell by nearly half a million, and the overall labor force rose by nearly two million during the last 16 months. However, we expect the job market to move at a less brisk pace for the rest of the decade. Slower economic expansion together with a huge supply of prime-age laborers should keep the unemployment rate close to 7 percent for the coming five years. The decline in numbers of the teenage work force should be more than offset by continuous growth in the female labor force, which will maintain some upward pressure on the unemployment rate.

## PRODUCTIVITY

### The Recent Experience

In the long run, a nation's standard of living and, to a great extent, its international competitiveness, are determined by its productivity growth. Only by increasing the real output (GNP) per unit of effort (e.g., an hour worked by an average employee) can living standards be improved. In recent years, mounting concern has been focused on the apparent decline in measured productivity growth in the U.S. economy since about 1973.

If the official government data on productivity (defined as real GNP per hour worked in the business sector) are essentially accurate, they imply a slowing of gains in living standards as well as a probable deterioration of the international competitiveness of U.S.-manufactured products. Major questions have been raised, however, regarding both the meaning and the accuracy of these data. This section will discuss the apparent longer-term trend in productivity growth, the current debate over interpretation of the numbers, and the forces that will be affecting productivity growth in the U.S. economy through 1989.

Over the interval spanned by post-World War II productivity data, from 1947 to 1983, output per hour worked in the private business sector (the government and farm sectors are excluded due to structural differences) expanded at a compound annual rate of 2.4 percent. That 36-year history is frequently divided into several subintervals for more precise analysis. From 1947 to 1965, when labor force growth was relatively slow (1.3 percent per year) and when the labor force participation rate was very stable, productivity growth averaged 3.3 percent annually. During the 1965-1973 interval, young people born during the 1940s and 1950s began to swell the labor force which grew 2.3 percent per year. Productivity growth during these eight years fell to 2.4 percent — still a respectable performance considering the large numbers of new workers who were presumably less productive than more seasoned members of the work force.

The government data show a major shift in productivity beginning in about 1973. From 1973 to 1983, productivity gains in private business averaged only 0.9 percent per year while growth in the labor force continued at about the same rate (near 2.2 percent) as during the prior period. The interpretation of this slowdown during the past decade or so has been a hotly debated issue.

### The Productivity Slowdown — Or Was It?

There have been numerous efforts to explain the recent slow growth of productivity, and at least two fundamentally different approaches have emerged. The more traditional approach has been to accept the published data as essentially valid and to seek to explain the slowdown statistically. More recently, a second approach has challenged the validity of the recent data and even questioned the existence of a slowdown in productivity growth.

The former approach generally proceeds by examining the determinants of productivity in an effort to explain the slowdown by finding evidence of shifts in the determinants. The relatively poor investment climate of the 1973-1983 period generally leads the list of suspected causes of the slow productivity growth of that period. Business fixed investment grew only two percent per year from 1973 to 1983, compared with the 4.1 percent annual growth rate of 1947-1973. The slowdown in capital spending has in turn been related to the disruptive effect of the OPEC oil embargo of 1973 and the deterrent effect of high inflation and interest rates in a tax environment that encouraged spending and penalized saving.

Other factors that have frequently been cited in this type of argument have been the environmental legislation of the 1970s, which required a large portion of capital investment to be placed in "nonproductive" pollution control equipment; the relatively strong labor force growth of 1973-1983, and, in particular, the large increase in the numbers of teenagers and women; slow growth in private and public spending for research and development; and the changing mix of the economy toward a larger service sector, where advances in productivity have been more difficult to achieve.

## LONG-TERM U.S. ECONOMIC OUTLOOK

**1983-1989**
**(billions)**

| | Current $ | | 1972 $ | |
|---|---|---|---|---|
| | **1983** | **1989F** | **1983** | **1989F** |
| Gross National Product | 3310.5 | 5749.8 | 1535.3 | 1872.5 |
| Personal Consumption Expenditures | 2158.0 | 3590.2 | 1011.4 | 1194.4 |
| Durable Goods | 279.4 | 495.0 | 156.3 | 208.9 |
| Autos and Parts | 133.8 | 251.9 | 68.0 | 90.6 |
| Except Autos and Parts | 145.6 | 243.1 | 88.3 | 118.3 |
| Nondurable Goods | 804.1 | 1248.5 | 376.1 | 423.5 |
| Services | 1074.5 | 1846.7 | 479.0 | 562.0 |
| Gross Private Domestic Investment | 472.0 | 969.7 | 219.0 | 313.9 |
| Fixed Investment | 478.4 | 920.9 | 221.1 | 298.5 |
| Nonresidential | 348.4 | 675.5 | 168.4 | 232.2 |
| Producers' Durable Equipment | 217.3 | 426.6 | 118.8 | 171.1 |
| Structures | 131.1 | 248.9 | 49.7 | 61.1 |
| Residential | 130.0 | 245.4 | 52.7 | 66.3 |
| Change in Business Inventories | −6.5 | 48.8 | −2.1 | 15.4 |
| Government Purchases | 689.5 | 1206.1 | 293.1 | 341.7 |
| Federal | 274.9 | 514.1 | 117.8 | 150.7 |
| Defense | 200.3 | 400.1 | 84.2 | 114.7 |
| Nondefense | 74.5 | 114.0 | 33.6 | 36.0 |
| State and Local | 414.7 | 692.0 | 175.3 | 191.0 |
| Net Exports | −9.0 | −16.2 | 11.8 | 22.5 |

F = SPNB Forecast

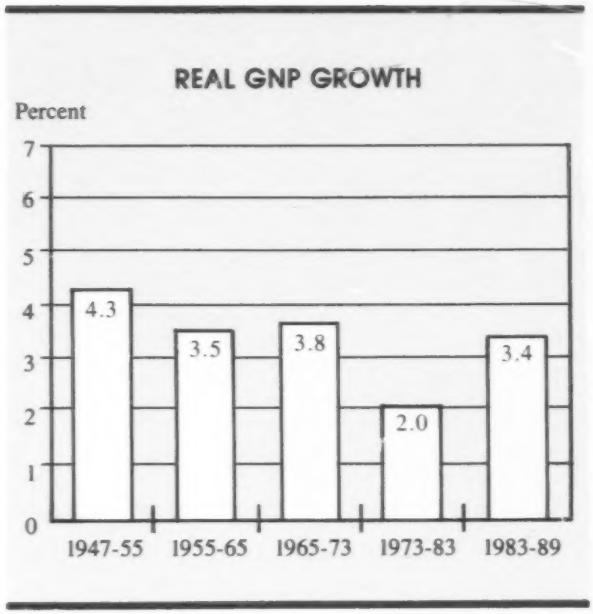
Typically, studies of the preceding type leave much of the apparent decline in productivity unexplained. The inconclusive nature of the research on causes of the productivity slowdown gave rise to a new approach — one which questions the accuracy of the data. A 1982 study by Professor Michael Darby of UCLA examined productivity growth from 1900 to 1978. After performing adjustments for differences in labor quality (age, sex, education, and immigration) in several intervals of the 78-year period, Darby found no substantial variation in *trend* growth rates of private labor productivity since 1900. Particular attention was focused on the period of 1965 to 1978, during which there was a pronounced slowing in the unadjusted productivity data, essentially similar to that previously noted between the data for 1965-1973 and that for 1973-1983. Darby found that bias induced by the price controls in effect from 1971 to 1974 resulted in understating inflation (and thus, *overstating* real output and productivity) while the controls were being imposed in 1971 and 1972, and overstating inflation while the controls were being relaxed and removed in 1973 and 1974.

While Darby's work is admittedly not exhaustive of all possible interpretations of the productivity data, it strongly argues that the "problem" of the last 10 years or so may not be as great as indicated by a literal reading of the raw data.

### The Outlook for Productivity Growth

Whether or not one accepts the validity of the apparent slowing of productivity growth during the last 10 years, the official measure of output per hour worked is likely to show considerable improvement in trend from 1983 to 1989. Initially, productivity has improved because the economic recovery that began in December 1982 has been putting idle capacity back to work at a rapid pace. Productivity in the private business sector of the economy increased 3.3 percent last year, and appears headed for a more moderate but still respectable gain in 1984. Abstracting from the business cycle, the trend rate of productivity growth in 1985 and beyond depends importantly on the extent to which the nation modernizes its capital stock.

Of particular importance is the "information" sector of the economy. Historically, service industries have been labor-intensive relative to manufacturing, and the shift in the structure of the U.S. economy toward services has been considered a force for lowering the rate of productivity growth.




However, the industries that comprise the burgeoning information sector of our economy differ from traditional service industries in that they are more capital-intensive, and frequently involve a high degree of technological sophistication. Consequently, productivity gains in this sector are likely to be large.

Balancing these factors, productivity growth in the 1983-1989 period is likely to be stronger than during the last 10 years (at least, on the basis of official statistics), but still below the long-run historical average of 3 percent that prevailed from 1947 to 1973. We are projecting a trend rate of productivity gain of 1.6 percent between 1983 and 1989.

## THE OUTLOOK FOR REAL GROWTH

If the period since November 1982 — the bottom of the last recession — is to have any lesson for the economics profession, it is to remind us that the U.S. economy is still very, very resilient. The recovery that began in December 1982 was expected, not just by naysayers, but by a general consensus of economic forecasters, to be mild — on the order of 3 percent real GNP growth for the first four quarters. The actual growth rate for the

four quarters ending in December 1983 was 6.2 percent, or about the average for the first year of economic recovery in post-World War II business cycles. The U.S. economy is now embarked on what looks like a typical second year of economic expansion, with a real growth rate of better than 4 percent likely for 1984.

In view of this surprisingly strong recent performance, and in spite of potential problems posed by still-large deficits in the federal budget and balance of payments, we think the 3.4 percent real compound annual growth rate incorporated in our projections for 1983-89 is easily attainable. Even after a strong first year of economic recovery, the private sector of the economy is still very liquid, and debt ratios for consumers are well below historic highs, indicating the potential for continued strong consumer spending. Although inflationary pressures appear to be mounting, the peak inflation rate for the current business cycle — perhaps in 1985 or 1986 — is expected to be well below the pace of 1979 through 1981. The rise in interest rates that occurred in the first half of 1984 is expected to continue on an upward trend in 1985, although we do not expect interest rate levels to reach their prior peaks in this cycle.

The key variable in the outlook for the next five years remains the nation's ability to control and redirect federal spending sufficiently to reduce the burden of the deficit as a percentage of GNP. Based on our projection that the government's claim on resources will be reduced as a percentage of total output between now and 1989, the private sector should be able to expand at a relatively high growth rate.

## GNP GROWTH AND SECTORAL SHARES

| | 1983-1989 Growth Trend | | Share of GNP (Current $) | | Share of GNP (1972 $) | |
|---|---|---|---|---|---|---|
| | (Current $) | (1972 $) | 1983 | 1989F | 1983 | 1989F |
| Gross National Product | 9.6 | 3.4 | 100.0 | 100.0 | 100.0 | 100.0 |
| Personal Consumption Expenditures | 8.9 | 2.8 | 65.2 | 62.4 | 65.9 | 63.8 |
| Durable Goods | 10.0 | 5.0 | 8.4 | 8.6 | 10.2 | 11.2 |
| Autos and Parts | 11.1 | 4.9 | 4.0 | 4.4 | 4.4 | 4.8 |
| Except Autos and Parts | 8.9 | 5.0 | 4.4 | 4.2 | 5.8 | 6.3 |
| Nondurable Goods | 7.6 | 2.0 | 24.3 | 21.7 | 24.5 | 22.6 |
| Services | 9.4 | 2.7 | 32.5 | 32.1 | 31.2 | 30.0 |
| Gross Private Domestic Investment | 13.3 | 6.2 | 14.3 | 16.9 | 14.3 | 16.8 |
| Fixed Investment | 12.1 | 5.1 | 14.5 | 16.0 | 14.4 | 15.9 |
| Nonresidential | 12.4 | 5.5 | 10.5 | 11.7 | 11.0 | 12.4 |
| Producers' Durable Equipment | 12.5 | 6.3 | 6.6 | 7.4 | 7.7 | 9.1 |
| Structures | 12.3 | 3.5 | 4.0 | 4.3 | 3.2 | 3.3 |
| Residential | 11.2 | 3.9 | 3.9 | 4.3 | 3.4 | 3.5 |
| Change in Business Inventories | — | — | −0.2 | 0.8 | −0.1 | 0.8 |
| Government Purchases | 9.8 | 2.6 | 20.8 | 21.0 | 19.1 | 18.2 |
| Federal | 11.0 | 4.2 | 8.3 | 8.9 | 7.7 | 8.0 |
| Defense | 12.2 | 5.3 | 6.1 | 7.0 | 5.5 | 6.1 |
| Nondefense | 7.3 | 1.2 | 2.3 | 2.0 | 2.2 | 1.9 |
| State and Local | 8.9 | 1.4 | 12.5 | 12.0 | 11.4 | 10.2 |
| Net Exports | — | 11.4 | −0.3 | −0.3 | 0.8 | 1.2 |

F = SPNB Forecast

The combined growth of the labor force, productivity, and hours worked per employee determine how rapidly the economy can grow over time. This is another way of looking at the concept of potential output discussed earlier in this report. Potential GNP is expected to grow at a compound annual rate of 2.6 percent from 1983 to 1989, compared with a 3.3 percent growth rate from 1973 to 1983. The slowdown in the growth of potential GNP in the 1980s is due to the more moderate expansion of the labor force, since productivity is expected to grow faster than during the 1970s.

Actual GNP is projected to grow by about 3.4 percent per year, somewhat faster than the growth in economic potential between 1983 and 1989. It becomes possible for the economy's actual growth rate to outdistance the growth of potential because at the starting point for this comparison, in 1983, the economy was operating about 10 percent, or more than $175 billion in 1972 dollars, below its potential growth path.

As a product of the expected trends in inflation (6.1 percent) and real growth (3.4 percent), current dollar GNP is projected to increase at a compound annual rate of 9.6 percent from 1983 to 1989. Total GNP should exceed $5.7 trillion in 1989 based on these projections, almost 75 percent greater than in 1983. We expect that the share of capital spending will increase during this period and that of consumption will decline. Large sums of money are now being spent on modernization not just in the high-tech sectors but also in key industries such as autos and steel, and corporate resources are being recombined in ways that will raise more capital to fund this spending.

The share of consumer spending in real output is expected to decline from the 65.9 percent share of 1983 (the highest in post-World War II history) to a more normal 63.8 percent in 1989. The share of non-residential fixed investment in real output is likely to increase from 11 percent in 1983 to 12.4 percent in 1989. Residential investment is projected to increase at a more normal 3.9 percent real growth rate compared with its 39.4 percent gain in 1983. Durable goods should experience the highest growth of any consumer category, with a projected five percent real growth rate. The federal government is expected to increase slightly its share of real output, due to the 5.3 percent real growth rate projected for federal defense spending. Net exports should increase its share of output due to faster export growth during this period spurred by a decline in the value of the dollar relative to other key currencies — a development that appears inevitable, although its timing is difficult to predict. ■

# THE UNITED STATES ECONOMY THROUGH 1989

## THE FINANCIAL ENVIRONMENT

Over the next five years, the course of both monetary and fiscal policy will be critical in determining the health of financial markets and, thus, of the economy. The November election will clearly affect how policy evolves, but assumptions must be made at this stage.

As discussed elsewhere, fiscal deficits are expected to be reduced over the next year or two from the levels widely projected in recent months. The deficit cutbacks will come via both tax changes and spending reductions. Nevertheless, persistent and large Treasury credit needs will remain and will be accompanied by substantial private credit needs, especially in the early years of the forecast period.

The current set of monetary policymakers appears determined to restrain growth in the supply of credit so that the next inflation peak is significantly below the last. Policymakers are, in fact, currently ignoring sluggish growth of the monetary aggregates in their policysetting process — focusing instead on strong economic and credit expansion. A new Fed chairman may lead the Federal Reserve toward a somewhat less restrictive course, but the near-term outlook is for continued restraint of credit supply.

After being negative throughout much of the 1970s, real (or inflation-adjusted) Treasury bill rates turned positive in 1980 and have remained so since then. In fact, real Treasury bill rates averaged more than four percent in 1983. The result of swollen credit demands and restricted supply will be continued high real interest rates in the years ahead.

Short-term rates are expected to be less volatile over the next five years than during the 1979-82 period when the Federal Reserve was strictly targeting the money supply. Rates stayed within a fairly narrow band (of approximately two percentage points) from late 1982 through early 1984. More substantial moves will come in the near-term, but no return to the violent swings of the 1979-82 period is anticipated.

We believe that the prime rate will average very close to 12 percent over the next five years and that high-grade corporate bonds will approximate 12.75 percent. While these averages (and others shown in the interest rate table) are very close to their current levels, we do not expect rate stability over the period. Rather, rates will rise as the economy approaches its peak over the next couple of years and will then fall as the economy enters recession. In other words, interest rates will follow their normal cyclical pattern but will simply average very close to current levels.

Our interest rate forecast for the next five years implies two important points relative to the five-year period from 1979 to 1983. First, though short-term rates are expected to average close to 1984 levels over the next

**INTEREST RATE OUTLOOK**
**1984-1989**

| | 5-Year Average 1979-83 | 1984 | SPNB Forecast 1984-89 Average |
|---|---|---|---|
| **Short-Term:** | | | |
| Prime | 14.50 | 12.00 | 12.00 |
| Commercial Paper — 90-Day Dealer | 11.94 | 10.25 | 10.50 |
| Treasury Bills — 3-Month | 10.95 | 9.85 | 9.75 |
| Federal Funds | 12.45 | 10.50 | 10.50 |
| **Long-Term:** | | | |
| Aaa Corporates | 12.31 | 13.00 | 12.75 |
| New Aa Utilities | 13.43 | 13.75 | 13.50 |
| Mortgage, Conventional — Commitment | 14.20 | 13.75 | 13.75 |

five years, they will be below their 1979-83 averages. Real interest rates (measured by the 3-month Treasury bill) will average 3.75 percent — which is high by long-term historical standards but is close to their 1979-83 level. Thus, the primary reason we anticipate lower interest rates in the upcoming period is our expectation of lower average inflation rates. Second, we expect the yield curve (that is, the ratio of long-to-short-term interest rates) to remain more positive over the period ahead than during the 1979-83 period.

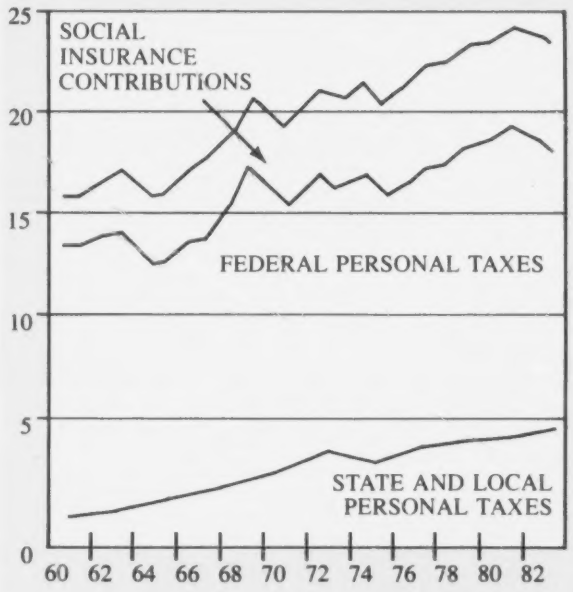
## GOVERNMENT SECTOR

Both the absolute and relative size of recent and projected federal deficits has become a major political issue. From a unified budget deficit of $28 billion in fiscal year 1979, the federal government's fiscal position deteriorated to a record deficit of more than $195 billion in fiscal year 1983. By comparison, the unified budget deficit in fiscal year 1973 was $15 billion. Without legislative action and despite continued economic expansion and modest inflation, the deficit would likely increase steadily over the next five years, surpassing the $200 billion level by fiscal year 1986. Repeated deficits of such size would necessarily imply a near doubling in the government's outstanding debt by the end of 1989.

The explanation for this continuing deficit situation lies in the interaction of several factors. To be sure, a substantial portion of recent years' deficits was attributable to poor economic performance. Nevertheless, renewed and continued economic expansion will not be sufficient to reduce the deficits significantly even though federal receipts could be expected to grow more rapidly than outlays between 1983 and 1989 even without further legislation. That is, from fiscal 1983 levels, receipts would have to grow at a rate one third greater than that of outlays just to keep the deficit from increasing above that year's $195 billion level. Although for the current fiscal year, the growth rate of receipts could approach double that of outlays, this relative performance would be difficult to duplicate repeatedly as the rate of economic expansion moderates toward a long-term trend value.

Yet another often-mentioned factor is the tax legislation passed in 1981 and in particular the cut in the individual income tax rates. Although the economic stimulus will result in a recovery of some portion of the revenue loss, the immediate impact was an increase in the federal deficit. A broader perspective on this issue, however, is shown in the accompanying chart. As is clearly evidenced, the combined, effective, personal tax rate remains at an historically high level. In other words, the 25 percent reduction in federal tax rates was substantially offset by the combined effects of increased employee contributions for social insurance, bracket creep at the federal level, and a general increase in state and local taxes. (It should be noted that these receipts exclude any sales, excise, or property taxes paid.)

**PERSONAL TAXES AND CONTRIBUTIONS FOR SOCIAL INSURANCE AS SHARE OF TAXBASE**




Further complicating the deficit outlook is the indexing of the individual income tax. Beginning with calendar year 1985, the tax brackets, the zero bracket amount, and the personal exemption will be adjusted annually for inflation. The adjustment for a given calendar year will be based upon the percentage increase in the

Consumer Price Index in the fiscal year ending prior to a given calendar year. For example, the adjustment for 1985 will be based on the increase in the CPI between fiscal years 1983 and 1984 (currently projected to be 5 percent). Although not all federal spending programs are specifically subject to cost-of-living provisions, in a broader sense the outlays of any program would be inflation-sensitive if there is sufficient political pressure to maintain the existing service level. Thus, after 1984, the deficit problem will be increasingly sensitive to any acceleration of inflation since one-third of federal receipts will respond only to real economic growth.

A political consensus appears to be building that would result in modest reductions in projected current services deficits. Adoption of a multi-year deficit reduction package appears likely this year. With additional legislation expected in future years, unified budget deficits of between $180 billion and $200 billion are likely throughout the period. Although details of these measures are uncertain, especially in a presidential election year, one third of the total dollars will probably result from miscellaneous tax law revisions with the balance coming from both defense and nondefense spending categories. The additional revenue will likely be generated from a variety of excise taxes and broadening both the individual and corporate income tax bases; however, neither the repeal nor postponing of the indexing of the individual income tax is considered likely.

On a National Income Account basis, the most rapidly growing outlay category will be defense purchases, even with a more modest defense buildup than desired by the Administration. To a great extent this pattern is the result of the modernization program begun several years ago and expected to continue in future years. Because of the long lead-time involved with development and procurement of new weapons systems, actual budget outlays occur some years after the spending was authorized.

Purchases by state and local governments are expected to increase at an annual rate of 8.9 percent between 1983 and 1989, or 1.4 percent in real terms. The largest share of these outlays will continue to be related to education with most of the remaining purchases associated with income support and medical programs, as well as with transportation.

## THE OUTLOOK FOR INFLATION

One of the most important and remarkable economic "success stories" of the last two years has been the significant decline in the nation's inflation rate. The growth path of prices has not only slowed dramatically, but has also decelerated at a much faster rate than expected by analysts using traditional forecasting models.

Measured by any price index, inflation in 1983 was but a small fraction of its previous values. For example, the Consumer Price Index, which rose 13.5 percent in 1980, and 10.3 percent in 1981, rose just 3.2 percent last year. Similarly, the GNP deflator, which is generally regarded as the broadest measure of inflation, advanced just 4.2 percent in 1983, after recording gains of 9.0 percent in 1980, and 9.4 percent in 1981.

Recent headlines of good news on prices have prompted several economists to claim that inflation is no longer a serious problem, and that a fairly robust business expansion with stable prices is a likely scenario. The most recent data, however, have cast some doubt on this proposition. The Producer Price Index rose at a 6.0 percent annual rate in the first quarter of this year, after increasing only 1.6 percent during 1983. Although dismissed as a statistical aberration by some economists, this news has nevertheless generated a considerable amount of "jitters" on Wall Street.

Inflation occurs when the current dollar value of aggregate demand (demands by consumers, business, and governments) grows faster than the supply of goods and services. In an economy with a managed paper currency such as the United States, inflation cannot realistically be a persistent problem unless monetary and fiscal policy allow for continued rapid expansion in aggregate demand. Typically, fast growth in demand is generated by a substantial increase in the money supply. Similarly, reductions in the rate of inflation typically follow significant reductions in the growth rate of the money stock.

Moreover, this type of monetary phenomenon is not unique to the United States. In several studies of inflation across countries, the "common denominator" behind rising prices is invariably the relative behavior of each country's monetary policy. As shown in the following table, countries with high growth rates of money typically have high inflation rates, and countries with modest expansionary policies have modest inflation.

**CROSS COUNTRY COMPARISON OF CURRENCY AND INFLATION**
**(Post-war Average Annual Growth Rates)**

| Country | % Change Prices | % Change Currency |
|---|---|---|
| Chile | 89.0 | 97.0 |
| Argentina | 72.8 | 70.2 |
| Uruguay | 42.0 | 41.5 |
| Brazil | 29.8 | 33.1 |
| Bolivia | 22.7 | 26.8 |
| | | |
| United Kingdom | 6.2 | 7.0 |
| Norway | 5.5 | 7.0 |
| Belgium | 4.0 | 4.9 |
| United States | 3.8 | 4.9 |
| Switzerland | 3.2 | 5.5 |

Although a positive relationship does exist between money and inflation over long periods of time, this correlation is often far from perfect in the short run. This deviation can frequently be accounted for by exogenous supply "shocks" to the economy, such as petroleum supply disruptions, and poor weather which can affect crop yields.

Many economists have suggested that the severity of our most recent experience with inflation can be partially traced to the substantial price increases which occurred in the energy and food sectors during the late 1970s. Those factors undoubtedly pushed measured inflation higher, just as declining energy prices and abundant harvests have had a moderating effect on the cost of living. However, it is important to recognize that significant changes in sectoral prices can have only transitory effects on inflation, because they are changes in the relative price of a good, not the general level of prices.

It is possible, however, for supply shocks to result indirectly in persistent inflation if they significantly affect the behavior of the Federal Reserve. For example, the instances of oil price shocks in the 1970s coincided with fairly stimulative monetary policy. This might indicate that the Federal Reserve was in effect willing to risk higher inflation in hopes that faster money growth could offset the negative output effects of the petroleum supply disruptions.

The prospective federal deficits will likely be a key factor influencing inflation over the next five years. One way in which federal borrowing contributes to inflation is through "monetization" of the deficit. This occurs when the Federal Reserve, acting as the Treasury's banker, purchases a portion of the government debt. This results in an increase in the money supply and ultimately higher inflation. With the Fed committed to achieving predetermined growth of monetary aggregates, there is clearly no guarantee that the Fed will monetize federal deficits over the forecast period. However, they certainly will be under a great deal of political pressure, particularly if heavy government borrowing begins to "crowd out" private credit demand with higher real interest rates.

As a result of fairly accommodative fiscal and monetary policies, inflation should continue to rise at a significantly faster pace than last year. Security Pacific Bank estimates that prices, as measured by the GNP deflator, will grow at a rate of 6.1 percent through 1989. Similarly, the Consumer and Producer Price Indexes are expected to increase 6.3 percent and 6.2 percent, respectively.

A return to moderate oil price hikes should help keep measured inflation out of the double-digit range. Recent evidence suggests that OPEC pricing behavior over the remainder of the decade may be quite different from that of the 1970s. Declining prices for petroleum products and excess drilling capacity in the producing countries indicate that foreign oil exporters are no longer the dominant players in the game. As the world economy continues to expand this year, oil demand should increase modestly and may result in higher crude oil prices However, the likelihood of petroleum price rises equivalent to those of the 1970s is not high at this time.

By sector, prices are not expected to vary substantially from the average, although the cost of government purchases and import prices are expected to rise somewhat faster. Higher prices for government purchases reflect the possibility of cost overruns as the demand for defense-related items rises substantially, while our forecast for import prices recognizes the likelihood of a decline in the value of the dollar in currency exchange markets during the next five years.

As inflation seems to have become a regular part of economic life, policymakers have been recently discussing several proposals designed to cure chronic inflation. One of the most popular of these propositions has been the resumption of the gold standard.

Under the gold standard, all U.S. currency could always be exchanged for a fixed amount of gold. Proponents of a gold-backed dollar frequently point out that inflation was not a major problem when the U.S. was on a gold standard (1879-1914). While their assertion is certainly true, it does not mean that prices were perfectly stable; between 1895 and 1912, the purchasing power of the dollar declined 40 percent.

Like any other commodity-based standard, a gold-backed dollar would have beneficial effects against inflation in the sense that it would significantly limit the government's ability to create money and may lower inflationary expectations. However, the cost of the gold standard today would likely be prohibitive. The volatile price fluctuations which currently characterize the gold market could easily place the U.S. on a wild roller coaster of inflation and deflation.

There is no good reason why good inflation performance cannot be achieved under our current paper standard. However, it will require a very firm commitment to fiscal and monetary restraint.

## CONSUMER SPENDING

Consumer spending is likely to grow somewhat less rapidly than real GNP from 1983 to 1989, partly due to the surge of consumption in 1983, when real spending grew 5.4 percent. Most of the same forces that fueled retail spending in 1983 are still present in 1984, including strong growth in employment and real disposable income. Additionally, the existence of a large pent-up demand for durable goods produced a boom in spending for motor vehicles, home furnishings and appliances, and a wide variety of other goods.

Even after a full five quarters of economic recovery, households are still in a very liquid financial position, which has favorable implications for continued strength in consumer spending in the coming years. One common measure of the debt burden of the household sector is the ratio of consumer installment debt to personal income. That measure, which increased from 12.8 percent in the fourth quarter of 1982 to 13.3 percent by the end of 1983, is still considerably below the recent peak reading of 15 percent in the second quarter of 1979.

The expectation of a continued high level of real interest rates, however may restrain consumer spending for durable goods somewhat during the coming years. The continued existence of a sizeable backlog of demand for automobiles is underscored by a simple fact — the age of the average car on American roads remains near seven years, indicating a large replacement demand for aging autos. That demand has been partially blunted, however, in the opinion of some observers, by the existence of import quotas on Japanese autos that have had the effect of limiting price competition, particularly at the lower-priced end of the market.

There is also some reason to expect that the equilibrium size of the auto stock in the latter 1980s will be lower in relation to population and income than in the 1970s due to the gradual aging of the population, changing tastes for personal transportation, an increase in the proportion of the household budget going to housing, and other variables. Our trend projection for sales of passenger cars, including imports, during the 1983-1989 period is 10.5 million per year, which is only a modest increase from the 10.1 million average annual sales rate of the 1970s decade.

Consumer spending for nondurable goods is projected to increase at an annual rate of 2 percent from 1983 to 1989. The trend growth rate for nondurables covers a wide variety of behavior by individual categories. Food expenditures (not including restaurant meals, which are considered services in the national income and product accounts) are the largest single category, accounting for about half of nondurables. Food purchases for home consumption are expected to grow at a relatively weak annual rate of 1.5 percent, showing a very gradual secular decline as Americans continue to dine out more frequently. Clothing and shoes purchases are projected to increase 3.3 percent per year, the strongest gain of any nondurable category. "Other" nondurable goods expenditures, which is a catch-all category that includes everything from newspapers to potted plants, includes many popular lifestyle-related items that are resulting in a relatively high growth projection of 2.9 percent per year. Declines are projected for real consumer spending for gasoline and oil (down 1.1 percent per year) and fuel oil and coal (down 0.9 percent annually). These savings will result from

factors such as improved fuel economy for the auto and truck fleet and decreased reliance on fuel oil and coal for residential heating.

Consumer spending for services is projected to increase at a relatively strong annual rate of 2.7 percent from 1983 to 1989. Housing services are projected to be the fastest-growing category in this group, with an annual real growth rate of 3.1 percent. Transportation services will expand at an annual rate of 2.9 percent, primarily reflecting the operating expenses (excluding fuel) associated with the expanding stock of user-operated motor vehicles. Household operating expenses are expected to grow 1.7 percent per year, reflecting increased spending for electricity (up 2.4 percent per year), and "other" household operating expenses (up 1.7 percent per year), with a decline in household spending for natural gas (down 1.1 percent per year). Lastly, another very large category of "other" consumer service expenditures, which includes mainly personal care, medical care, personal business, recreation, and private education expenses, is projected to grow 2.7 percent per year.

## THE OUTLOOK FOR INVESTMENT

One of the most distinguishing features of post-World War II economic activity is the cyclical sensitivity of investment in equipment and structures. During business downturns, capital spending almost always declines more rapidly than total GNP, and similarly, exhibits a more robust recovery during subsequent expansions. after declining 4.7 percent in 1982 and increasing a slight 1.4 percent in 1983, business fixed investment is expected to rise over 13 percent in 1984.

However, it should be noted that the long-term record for capital spending since the 1960s has not been particularly strong. Between the late 1960s and 1970s, the share of real output devoted to nonresidential fixed investment has declined by more than 30 percent, while the growth rate of the nonresidential capital stock decreased nearly 40 percent.

Our analysis suggests that some of the most important factors which have affected private investment are the rate of inflation, the existing tax structure, and the performance of common stock prices. The interactive effects of inflation and the existing tax code distort the relative return to business capital in two principal ways. First, an increase in the rate of inflation lowers the real value of depreciation costs. This is an especially significant problem during periods of unanticipated inflation. Secondly, common stock shareholders pay capital gains tax on nominal increases in the value of their stock. During inflationary periods, this means that personal investors must pay taxes on price appreciation even if the real value of their equity has declined. Inflation does provide an incentive for firms to issue debt since nominal interest payments can be deducted from firms' taxable income. However, this effect is partially offset because bondholders, like stockholders, pay taxes on nominal interest income.

Recently, there has been a great deal of interest in the "Q-theory" of investment. Developed by Nobel laureate James Tobin, the Q-theory examines the relationship between business investment and the performance of stock prices. The theory is based on the hypothesis that stock prices, which represent the market value of publicly-held corporations, are much more volatile than the market prices of new capital goods. When stock prices rise faster than the reproductive costs of capital, investment tends to accelerate, since any additions to a firm's capital stock will be valued at a higher price (in the stock market) than the acquisition cost

Recent experience seems to accord well with the Q-theory of investment. During the 1970s, the purchase price of capital advanced rapidly, while common stock prices performed poorly. As a result, the growth rate of capital spending during the decade declined markedly. Similarly, the recent dramatic run-up in securities prices coupled with very modest increases in the cost of capital goods has produced a very significant improvement in investment. Since there are often long lags present in investment behavior arising from delays in appropriations to expenditures on the part of firms and delays in delivery and production time from suppliers, it is reasonable to conclude that the 1982-1983 surge in stock prices should continue to stimulate business fixed investment over the next several quarters.

On the negative side, however, historically high real interest rates are expected to have a significant negative effect on capital spending over the forecast period. High real rates have depressed fixed investment by damaging corporate balance sheets and by encouraging firms to conserve cash and purchase high-yielding securities rather than committing funds to long-term projects.

Additional evidence points to a favorable outlook for investment over the next five years. Automobile sales, which often lead the recovery in equipment spending, have improved markedly. Major manufacturers are already phasing out old equipment and are currently in the midst of a substantial re-tooling project. New orders for manufactured goods have been increasing for some time, with particular strength evidenced in the basic industries. Moreover, fundamental factors such as capacity utilization and industrial production continue to rise, while oil prices, which are an important component of the cost of operating capital goods, should increase only moderately.

Security Pacific Bank's forecast calls for nonresidential investment to advance 5.5 percent annually, reflecting a 6.3 percent growth rate in producer's durable equipment and a 3.5 percent growth rate in structures investment. Improving corporate profits and balance sheets, combined with rapid technological advances, should result in manufacturers' increasing real equipment investment significantly. Investment in nonresidential structures will increase more slowly, reflecting the current availability of office space in major cities.

An important assumption behind this forecast is that there will be no major changes to the current tax code. Any substantial tax increases would likely result in smaller gains in capital spending.

## CORPORATE PROFITS

After-tax profits rose last year for the first time since 1979. Between 1979 and 1982, after-tax profits plummeted 30 percent to $115.1 billion, the lowest level since 1976. After-tax profits in 1982 equalled only 3.7 percent of GNP, the lowest share since 1935 and substantially below the 5.7 percent average for the 1970s. Last year was one of transition during which profit growth turned significantly upward in the second half of the year following a weak beginning. Even with the 15 percent increase recorded last year and the projected increase this year, after-tax profits would represent only about 4.5 percent of GNP.

Nonfinancial corporations account for almost 60 percent of total output and 63 percent of total wages and salaries earned by the U.S. labor force. From 1979 through 1982, declining output and soaring unit labor costs resulted in a 31 percent decline in profits from current production (economic profits). Another factor in the poor profit performance was the weakened balance sheet position of these corporations. During the late 1970s and early 1980s, unreceptive equity and long-term debt markets forced these corporations into an increasingly leveraged position, financed with short-term debt; thus, their profits were particularly vulnerable to the dramatic rise in interest rates that occurred.

Last year, operating profits of nonfinancial corporations rose 43 percent to $178 billion as a result of the increase in production levels and lower interest rates. The improved earnings positions were utilized to strengthen balance sheets by acquiring liquid assets, lengthening debt structures, and capitalizing on an improved market for equities. Another factor that played a major role in the turnaround in profitability was the dramatic slowing in the upward trend of unit labor costs. After increasing an average 8.9 percent annually during the previous three years, unit labor costs rose only 1.5 percent in 1983, with an increase in hourly compensation of only 5.1 percent and an increase in productivity of almost 3.5 percent. (In fact, the productivity performance last year was the best since 1971.)

Last year's increase in profits actually understates the improvement in the earnings capacity of the corporate sector. Corporate cash flow (retained earnings plus depreciation expense) benefitted substantially from the Accelerated Cost Recovery System of the 1981 tax cut. Although this system necessarily reduces profits by increasing the depreciation expense allowable for tax purposes, corporate cash flow is increased by a ratio of roughly three to two. Under the tax laws existing in 1980, 7 percent of taxable profits were directly attributable to the understatement of true economic depreciation. That is, inflation had increased the replacement cost of plant and equipment, but depreciation for tax purposes was based upon acquisition

## CORPORATE PROFITS OUTLOOK
**1983-1989**

| | Current $ Billions | | | Growth Trend | |
|---|---|---|---|---|---|
| | 1973A | 1983A | 1989F | 1973-83 | 1983-89 |
| Operating Profits (with IVA and CCADJ) | $108.3 | $229.1 | $462.7 | 7.8 | 12.4 |
| Nonfinancial Corporations | 78.6 | 177.9 | 391.8 | 8.5 | 14.1 |
| Inventory Valuation Adjustment | −20.0 | −9.2 | −33.0 | — | — |
| Capital Consumption Adjustment | 2.7 | 30.8 | 64.0 | — | — |
| Corporate Profits Before Taxes | 125.6 | 207.5 | 360.8 | 5.1 | 9.7 |
| Corporate Profits After Taxes | 76.5 | 130.6 | 244.7 | 5.5 | 11.0 |
| Dividends | 27.0 | 73.3 | 91.7 | 10.5 | 3.8 |
| Retained Earnings | 49.5 | 57.3 | 153.0 | 1.5 | 17.8 |
| Internal Cash Flow | 123.2 | 319.7 | 661.0 | 10.0 | 12.9 |
| (Retained Earnings plus Depreciation) | | | | | |

F = SPNB Forecast

costs. This discrepancy more than offset the beneficial effect of any then-existing depreciation provisions. By contrast, in 1983 the allowable write-off of plant and equipment exceeded economic depreciation by some $32 billion, or 15 percent of before-tax profits.

The long-term outlook for profits depends on four critical factors: 1) a sustained economic expansion, 2) a modest and less volatile rate of inflation, 3) a moderate cyclical rise in interest rates, and 4) a return to the historical growth in productivity. As discussed elsewhere, productivity gains over the forecast horizon are expected to be double the rate of the past decade. Hourly compensation rates, however, are expected to accelerate from last year's pace. A rebounding economy, along with widely publicized profit gains, will preclude the sort of major wage concessions made in recent years and might even intensify demands for reinstatement of a portion of those concessions. Nevertheless, with the projected productivity gain, the increase in unit labor costs will likely remain below 5.5 percent. The decline in interest rates last year had a greater than normal effect in reducing net interest costs of nonfinancial corporations because short-term debt still accounted for an historically large share of total debt. Although these corporations were able to achieve some balance sheet restructuring, as discussed previously, their earnings capacity remains vulnerable to any sharp rise in interest rates. Furthermore, continued increases in profits of the thrift industry depend upon the continued recovery in the housing industry and only moderate increases in interest rates.

In 1984, after-tax profits are again expected to increase strongly, registering a gain of approximately 25 percent. The projected continuation and broadening of the economic expansion will further increase operating rates. Inventory rebuilding, following a record depletion, will yield increased inventory profits. Finally, a modest rise in unit labor costs relative to prices will play a major role in maintaining profit margins. From 1985 through 1989, however, the growth of profits is expected to slow considerably. There are two fundamental reasons for this deteriorating performance. Profit margins will come under downward pressure from an acceleration in unit labor cost increases as well as from increased financing costs. In addition, as the economic expansion matures, the volume of output will rise more slowly.

### THE FOREIGN SECTOR

The external sector of the U.S. economy is expected to show modest improvement during the 1983-1989 period. Starting from the depressed 1983 level of $11.8 billion, real net exports are projected to increase to $22.5 billion by 1989. The net real export number is projected to deteriorate further during 1984 and 1985 before showing its improvement as we move into the later portion of the decade.

The nation's trade deterioration in 1984 is due to the strong import pull of the high U.S. economic growth rate. This effect was more pronounced than the impact on U.S. exports resulting from the lagged economic recovery in the nation's major trading partners. These factors, coupled with the effect of the strong dollar, continue to produce huge monthly trade deficit numbers. The trade and current account forecasts continue to be revised upward, with the most recent deficit numbers for 1984 standing at $100 billion for trade and $80 billion for the current account. During late 1984 and into 1985 the slowing U.S. economy, coupled with the acceleration in trading partner economic growth rates, will begin to produce modest improvement in these numbers. However, they will remain at huge historic deficit levels.

During the period to 1989, the dollar's value is projected to erode rather than to undergo a sustained precipitous drop in value. This forecast is underpinned by our inflation and interest rate outlooks. However, fiscal deficit implications are mixed. Huge fiscal deficits may produce higher inflationary expectations — which are negative for the dollar — but they will also produce higher interest rates — which are generally positive for the dollar because they bring in capital from abroad.

Another powerful factor favoring capital movements into the U.S. economy is the world political situation. Most outside disruptions tend to favor the dollar because of the nation's more insulated position. Disturbances in Eastern Europe adversely impact Western European currencies. Middle Eastern problems affect the Japanese yen and European currencies more than the U.S. dollar. Hence, although specific events are difficult to anticipate, the dollar is expected to be strengthened by world political events.

Even oil price developments have favored the dollar. Declining oil prices were viewed as disruptive and, hence, as more favorable to the dollar than to other currencies. Clearly, Europe and Japan are more dependent on imported oil than the United States. Those countries have recently, therefore, been net beneficiaries of oil price developments although not very powerful ones given the strength of the dollar. Flat to slightly rising oil prices become basically a neutral factor for the dollar during the forecast period. However, it should be noted that if oil prices should collapse (not the assumption of this study), that development would be more favorable to the dollar in a systemwide sense, as indicated by the strains to the international financial system which emerged during periods of high oil prices. It would also favor the dollar in a foreign policy sense, as it would eliminate a "hammer held over our head." And finally, paradoxically, skyrocketing oil prices would also generally favor the dollar. Hence, deviation from the base forecast would all tend to be pro-dollar.

The debt problem of the developing countries has generally been viewed by the markets as somewhat beneficial to the dollar. This is because it indicates a need for a greater supply of dollars which is mitigated by the negative impact on the U.S. financial system. Additionally, other nations are also exposed to problems resulting from the LDC debt situation. The assumption of this study is that these problems will be less severe at the end of the forecast period than now. This outlook arises from expectations of flat oil prices, less explosive interest-rate trends, and higher economic growth in the industrial countries. The last of these will result in a stronger pull on developing-country exports, less borrowing and, hence, fewer debt problems.

The world financial system will be buffetted over the next five years, but it is likely that the strains will be less severe than those of the last five years, which resulted from inflation and interest-rate binges. However, as has been stressed in this report, fiscal deficits in the United States and other industrial countries are the paramount threats overhanging world financial markets. As has been the case, no dramatic change in the world financial system is anticipated. The U.S. dollar is expected to remain supreme, with the European Monetary System becoming increasingly tattered, Japan hesitantly opening up its financial system, gold remaining in abeyance, and Special Drawing Rights in a holding-pattern. ■

# UNITED STATES INDUSTRY OUTLOOK

## UNITED STATES INDUSTRY OUTLOOK

During the 1973-83 period, U.S. industrial output increased at an annual trend growth rate of 1.3 percent. In contrast, the 1983-89 period presents a relatively robust outlook for U.S. industrial output, which is projected to grow at an annual rate of 4.9 percent. This projected growth in output is not confined to a few sectors of the economy, but instead is relatively broad-based. Of the 23 key industries analyzed, production of ten industries, mostly durables manufacturing industries, will increase more rapidly than total industrial production and only one industry, leather and leather products, is expected to register a decline during the 1983-89 period.

In the following table, the seven best-performing industries are grouped as high growth and the seven worst-performing as low growth industries. All the remaining industries are lumped together as medium growth industries. To facilitate inter-group and intra-group comparisons, all 23 key industries are ranked — highest to lowest — in terms of their relative growth prospects during the 1983-89 period.

### The High-Growth Industries

Most of the high-growth industries belong to the gross private domestic investment sector and manufacture producers' durable equipment; only a few turn out final products for consumers. Four major factors are responsible for the rapid growth of the business investment sector during the 1983-89 period. First, current monetary and fiscal policies are geared toward increasing investment outlays. Both interest rates and inflation rates are assumed to be somewhat lower over the projection period than during the previous 5-year

### COMPARATIVE INDUSTRY GROWTH
**(1983-89)**

| | Annual Trend Growth Rates (Percent) | |
|---|---|---|
| | **Production** | **Employment** |
| HIGH GROWTH | | |
| Nonelectrical Machinery | 7.39 | 4.54 |
| Rubber and Plastic Products | 7.20 | 2.46 |
| Electrical Machinery | 6.30 | 1.58 |
| Instruments | 6.15 | 2.18 |
| Transportation Equipment | 6.07 | 1.93 |
| Primary Metals | 5.83 | 3.09 |
| Ordnance | 5.50 | N.A. |
| MEDIUM GROWTH | | |
| Chemical and Products | 5.33 | 1.10 |
| Fabricated Metal Products | 5.29 | 2.51 |
| Stone, Clay, and Glass | 4.95 | 2.35 |
| Apparel and Products | 4.26 | 0.69 |
| Furniture and Fixtures | 3.81 | 2.93 |
| Printing and Publishing | 3.58 | 1.97 |
| Lumber and Wood Products | 3.54 | 1.47 |
| Textile Mill Products | 3.44 | 1.15 |
| Paper and Products | 3.36 | 1.34 |
| LOW GROWTH | | |
| Miscellaneous Manufactures | 3.22 | 0.94 |
| Food and Products | 2.81 | −0.36 |
| Mining | 2.39 | 0.48 |
| Utilities | 2.32 | N.A. |
| Petroleum Products | 1.54 | 0.91 |
| Tobacco Products | 1.46 | 0.25 |
| Leather and Products | −0.71 | −0.16 |

N.A. = Not available

period. Also, the Economic Recovery Tax Act of 1981 has enhanced the business sector's ability to finance investment. Second, the age structure of capital dictates that investment in capital must increase not only to replace retirements but also to modernize plants to make them economically more efficient and competitive. Third, labor costs are projected to rise faster than the rental price of capital, suggesting a shift toward more capital-intensive production processes. Finally, due to the general economic recovery, increased sales have pushed the industry very close to its most efficient level of capacity utilization. Therefore, the expected growth in demand over the forecast period can be met efficiently only if additional capital investment takes place.

The strong demand for sophisticated production equipment and modern specialized materials will make high-tech industries grow faster than the more traditional sectors of the industrial base. Thus, industries such as nonelectrical machinery, electrical machinery, instruments, and rubber and plastics products fall into the high-growth group. The overall improvement in the economy and relatively lower interest rates have been instrumental in reviving the motor vehicles and equipment and closely related industries. Also, due to the their versatility and improved properties, plastics materials continue to replace glass and metal. Finally, the current emphasis given to upgrading the United States defense capabilities is expected to boost defense-related industries. Consequently, the ordnance industry is expected to grow at an annual rate of 5.5 percent over the projection period. The growth in the durables manufacturing industries will provide significant growth incentives to the primary metal industries such as steel, copper, lead, and aluminum.

### The Medium-Growth Industries

The medium-growth category is comprised of both durables and nondurables manufacturing industries. All nine key industries comprising this group also reflect the expectations of greater investment spending occurring over the 1983-89 period than in the prior period. Led by the resurgence in the housing market, the construction-related industries are expected to show sizable gains. These industries include: lumber and wood products; stone, clay, and glass; fabricated metal products; and furniture and fixtures. The glass industry is also affected favorably by a healthy recovery in car and truck sales.

The remaining industries in this group, for the most part, are traditional industries that continue to show solid growth. These include nondurables manufacturing industries such as: chemicals and chemical products; paper and paper products; printing and publishing; textile mill products; and apparel and apparel products.

### The Low-Growth Industries

The seven key industries included in the low-growth group are miscellaneous manufactures, food products, mining, utilities, petroleum products, tobacco products, leather and leather products. Mining, leather and leather products have fallen victim to intense import competition. Availability of cheap labor and lack of environmental regulations give foreigners a competitive edge over the U.S. producers. Energy conservation, induced by high real oil prices, has slowed energy demand. This slowdown in energy demand, in turn, has retarded refinery output as well as mining and utility production.

The tobacco industry continues to be a low-growth field. A slowly growing population, price resistance, and health concerns are expected to have a depressing effect on tobacco consumption. Therefore, the tobacco industry is projected to grow at a compound annual rate of only 1.5 percent.

The food products category represents a group of more than 30 different food and beverage industries. Although the group is expected to grow at an annual rate of 2.9 percent over the 1983-89 period, certain industries within the group are expected to gain more than others or to gain at the cost of other industries.

## PAST AND FUTURE COMPARATIVE GROWTH RATES

In the previous section, 23 key industries were divided into three groups (high-growth, medium-growth, and low-growth) and then ranked, highest to lowest, in terms of their projected growth rates in output for the 1983-89 period. Also, the major factors responsible for differences in growth levels of the three groups were analyzed. The focus of this section is on the following

three points. First, the projected growth rates of all key industries are compared with their actual growth rates for the period 1973-83. Second, the projected growth rates are compared with the actual growth rates of the major industry sub-groups within each of the key industry segments. Finally, the expected employment situation in each of the key industry segments is evaluated for the 1983-89 period.

## INDUSTRY GROWTH AND REAL GNP

### Nonelectrical Machinery

Sixteen of the 23 key industry segments are expected to record real growth rates over the 1983-89 period that will exceed the trend growth rate of GNP (3.4 percent). The most rapidly growing of the sixteen will be the "nonelectrical machinery" segment with a projected trend growth rate of 7.4 percent. The major industries included in this segment are those producing engine and farm equipment; construction and allied equipment; metal working machinery; specialized and generalized industrial machinery; and office, service and miscellaneous equipment (see the following table).

Relatively high interest rates and low farm-commodity prices kept sales and production of farm equipment and machinery low through 1982. Sales and production were anticipated to increase in 1983 but the announcement of the PIK program and a spectacular response to it (83 million acres of farmland were idled) further lowered the need for planting and harvesting equipment in 1983. Thus, during the 1973-83 period, the farm equipment industry registered a decline at an annual rate of 5.6 percent. Since many farmers have deferred purchases of new farm machinery since 1981, pent-up demand, tax considerations, and a reduced or discontinued PIK program may be expected to stimulate increased purchases of farm equipment. Many manufacturers are predicting sales increases of 15 to 20 percent in 1984. However, a large portion of the machines that are sold will come out of current inventories.

Still, the farm equipment industry is projected to grow at an annual rate of 7 to 8 percent. Most of this growth will depend on farm income levels and the export market. Since the U.S. farm equipment industry is competing with Japan and Germany in the world market, particularly in smaller tractors, U.S. producers are expected to pursue product specialization in order to retain their market share in the long run.

The "metal working machinery" industry has three basic components: foundry equipment, industrial heating equipment, and welding equipment. Of these three components, foundry equipment has the most promising prospects for growth over the next five years. Since foundries must remain competitive with each other, as well as with other types of metal working processes, the demand for foundry equipment in the metal casting industry is expected to surpass the output of the industry. Continued economic recovery in the U.S. and in the rest of the world will enable the materials processing industry to purchase more cost-efficient heating and welding equipment. Therefore, the industry is expected to expand 6.6 percent annually over the forecast period, compared with almost no growth during the 1973-83 period.

The long-term growth of the construction and allied equipment industry will depend on continuation of the economic recovery, particularly rises in building construction, surface mining, and public works. In addition, improvements in the economies of our trading partners would increase exports, which account for more sales than any individual domestic market. Given continued economic recovery, the industry will grow very rapidly over the next two years and then slow down during the remainder of the forecast period. The overall growth rate is expected to be about 10 percent per annum.

The remaining industries in the nonelectrical machinery segment are also expected to expand at annual rates of 4 to 7 percent, given that the general economic recovery continues.

### Rubber and Plastic Products

During the 1973-83 period, rubber and plastic products were the fastest growing industry. Even though there are expanding uses for plastic products and substitution of plastic products continues, the growth rate has slowed due partly to foreign competition and partly to domestic environmental and safety regulations. Still, it is the second most rapidly growing industry segment in the U.S. with a projected trend growth rate of 7.2 percent over the 1983-89 period.

## COMPARATIVE GROWTH TRENDS

**(Compound Annual Growth Rates by Industry)**

| | Real Growth (%) 1973-83 | 1983-89 |
|---|---|---|
| **Nonelectrical Machinery** | **1.19** | **7.39** |
| Engine and Farm Equipment | −3.65 | 8.03 |
| Farm Equipment | −5.64 | 7.51 |
| Construction and Allied Equipment | −2.39 | 10.33 |
| Metal Working Machinery | 0.05 | 6.64 |
| Spec. and Gen. Industrial Machinery | −0.87 | 4.92 |
| Office, Service and Miscellaneous Equipment | 4.82 | 7.63 |
| **Rubber and Plastic Products** | **4.72** | **7.20** |
| Tires | 0.97 | 4.00 |
| Rubber Excluding Tires | −0.69 | 4.21 |
| Plastic Products | 7.37 | 8.21 |
| **Electrical Machinery** | **2.63** | **6.30** |
| Major Electrical Equipment and Parts | −1.12 | 6.23 |
| Household Appliances | −1.25 | 3.90 |
| T.V. and Radio Sets | −1.06 | 5.14 |
| Communication Equipment | 5.05 | 4.87 |
| Electronic Components | 5.46 | 7.71 |
| Miscellaneous Electrical Supplies | 2.64 | 5.67 |
| **Instruments** | **1.44** | **6.15** |
| Equipment Instruments and Parts | 3.18 | 6.34 |
| Consumer Instrument Products | −0.66 | 5.92 |
| **Transportation Equipment** | **0.01** | **6.07** |
| Motor Vehicles and Parts | −0.74 | 5.81 |
| Automobiles | −1.42 | 5.47 |
| Motor Vehicle Parts | −0.20 | 4.01 |
| Trucks, Buses and Trailers | −0.70 | 10.75 |
| Aircraft and Parts | 2.54 | 5.98 |
| Ships and Boats | 0.84 | 7.33 |
| Railroad Equipment | −14.80 | 26.26 |
| Mobile Homes | −5.42 | 4.10 |
| **Primary Metals** | **−3.87** | **5.83** |
| Iron and Steel, Subtotal | −5.22 | 6.43 |
| Basic Steel and Mill Products | −5.05 | 6.52 |

| | Real Growth (%) 1973-83 | 1983-89 |
|---|---|---|
| **Primary Metals (cont.)** | | |
| Iron and Steel Foundries | −5.83 | 5.96 |
| Nonferrous Metals, Subtotal | −2.00 | 5.10 |
| **Ordnance** | **1.62** | **5.50** |
| **Chemical and Products** | **3.35** | **5.33** |
| Basic Chemicals | 1.72 | 5.14 |
| Synthetic Materials | 4.10 | 6.27 |
| Drugs and Medicines | 5.13 | 4.89 |
| Soaps and Toiletries | 3.35 | 3.77 |
| Paints | 0.27 | 4.13 |
| Agricultural Chemicals | 4.50 | 7.83 |
| **Fabricated Metal Products** | **−0.37** | **5.29** |
| Metal Cans | −0.90 | 3.34 |
| Hardware, Plumbing, Structural Metal | −0.52 | 5.52 |
| Other Fabricated Metal Products | −0.13 | 5.30 |
| **Stone, Clay, and Glass** | **0.70** | **4.95** |
| **Apparel and Apparel Products** | **0.08** | **4.26** |
| **Furniture and Fixtures** | **1.72** | **3.81** |
| Household Furniture | 1.44 | 3.35 |
| Fixtures and Office Furniture | 2.50 | 2.28 |
| **Printing and Publishing** | **2.57** | **3.58** |
| **Lumber and Wood Products** | **0.85** | **3.54** |
| **Textile Mill Products** | **−0.15** | **3.44** |
| **Paper and Paper Products** | **1.80** | **3.36** |
| **Miscellaneous Manufactures** | **0.59** | **3.22** |
| **Food Products** | **2.62** | **2.81** |
| **Mining** | **0.16** | **2.39** |
| Oil and Gas Extraction | 0.25 | 1.34 |
| Other Mining | −0.05 | 4.53 |
| **Utilities** | **1.71** | **2.32** |
| **Petroleum Products** | **−0.63** | **1.54** |
| **Tobacco Products** | **−0.03** | **1.46** |
| **Leather and Leather Products** | **−2.91** | **−0.71** |

The major industries included in this segment are those producing tires, footwear, hose and belting, fabricated rubber products, and plastics. The future of the tire industry will continue to be influenced by the automobile industry. Since the number of automobiles in operation and the annual mileage driven are expected to expand in the next five years, the market for tires is projected to grow at an annual rate of 4.0 percent. Likewise, the future prospects for the hose and belting industry are closely linked with the automobile industry. However, expected improvements in other markets, such as industrial machinery, agriculture, and construction, will also increase the demand for hose and belting.

The rubber footwear industry will continue to be affected by import competition on the supply side and by fads and leisure activities on the demand side. As a whole, the "rubber excluding tires" industry is expected to grow 4.2 percent annually for the forecast period, compared with a very dismal –0.7 percent rate for the historical period.

Due to their versatility and improved properties, plastics materials have been successful in making inroads into markets formerly dominated by traditional materials such as metal, wood, paper, and glass. Given improved technology and requirements for new materials, the demand for plastics will continue to grow. Specialty materials, such as high temperature, reinforced, and conductive plastics, may provide good profit opportunities in the future. Therefore, the plastic products industry is anticipated to grow at an annual rate of 8.2 percent over the 1983-89 period.

### Electrical Machinery and Instruments

The economic recovery, recent changes in corporate income tax structure, and the emphasis on stimulating business investment are expected to benefit capital equipment industries over the 1983-89 period. Like the nonelectrical machinery industry, the electrical machinery and the instruments industries are projected to show strong performance. The principal industry sub-groups included are the major electrical equipment and parts industry, the electronic components industry, and the equipment instruments and parts industry. Within the major electrical equipment and parts industry, the transformer industry and the switchgear industry are not expected to grow substantially. However, the long-term outlook for the motor and generator industry is bright. Increasing use of energy-efficient motors will take place during the forecast period.

The electronic components industry has a promising outlook. Semiconductors, electronic capacitors, and electronic connectors lead the industry and are followed by components such as electron tubes, electronic resistors, electronic coils and transformers. The economic recovery is expected to increase the semiconductor needs of producers of mainframe and minicomputers, industrial and automotive electronics, telecommunications equipment, consumer-oriented products, and defense industries. Therefore, the electronic components industry is expected to grow faster than the electrical machinery segment (7.7 percent vs. 6.3 percent annually).

The growth of the equipment instruments and parts industry depends on the levels of capital spending on plant and machinery. Since capital spending is expected to grow at an annual rate of 5.5 percent over the forecast period, prospects for instrumentation companies seem bright. Moreover, trends toward increasing integration of computer technology with instrumentation will open new markets for the instruments industry. Also, the military market for instruments will remain strong during the next several years. All these factors combined are expected to double the growth rate of the equipment instruments and parts industry to 6.3 percent annually for the 1983-89 period compared with an annual growth rate of 3.2 percent over the 1973-83 period.

### Transportation Equipment

The transportation equipment segment consists of four major sub-groups: motor vehicles, aerospace, shipbuilding and repair, and railroad freight cars. All of these sub-groups face long-term competitive challenges from other countries, particularly the motor vehicles sub-group. Even though the current recovery will have a positive influence on the transportation equipment industry, its long-term growth will depend on continued capital improvements and reduction in production costs. Given capital improvement, lower production costs, and improving general economic conditions, the U.S. automotive industry will be able to compete in the world market. Based on these assumptions, the automobile industry is expected to grow at an annual rate of 5.5 percent from 1983 to 1989.

The outlook for trucks, buses, and trailers — including mobile homes — seems favorable. Increased fuel efficiency due to improved aerodynamics and use of lighter and stronger materials, along with stability in the supply and price of gasoline, will continue to boost sales of buses. Also, the truck trailer industry,

including detachable trailers, is expected to expand considerably during the forecast period because of tax incentives for investment, expected stability in the price and availability of diesel fuel, the new federal size and weight standards, and intermodal shipping, i.e., piggybacking trailers on railroad flat cars. All combined, the trucks, buses, and trailers industry is projected to grow at an annual rate of 10.8 percent over the forecast period, compared with declines over the historical period.

Similar upward trends are expected in other means of transportation. For instance, the aircraft and parts industry is projected to grow at a rate of 6.0 percent annually. Present trends suggest continued strength in military markets. Even though the civilian aerospace industry is, at present, at a low point, it is bound to reverse its direction because of two reasons. One, passenger traffic is expected to increase 5 to 6 percent per annum over the forecast period. Two, many existing aircraft will be retired prematurely to comply with FAA noise regulations (effective January 1, 1985) combined with similar regulations by several European countries.

Most of the projected rise in the shipbuilding industry will be due to the five-year Navy plan for fiscal years 1984-88 that includes 123 new ships and 21 conversions, acquisitions, and activations. Some replacement demand for small commercial tankers will materialize because of requirements under the Port and Tanker Safety Act of 1978 for compliance with certain pollution standards by 1986.

Within the transportation equipment segment, the railroad equipment industry is projected to grow at the highest rate, 26.3 percent annually. An improving economy and the consequent increase in the demand for railroad services will increase the demand for freight cars. The annual demand for new cars is forecast at 60,000 by 1988.

### Primary Metals

The primary metals industry consists of both ferrous and nonferrous metals. Among nonferrous metals, copper, lead, and zinc are not expected to exhibit much growth over the 1983-89 period. High production costs, environmental concerns, stiff competition from foreign producers, and the declining intensity of use will continue to slow the growth of these industries.

The outlook for aluminum, titanium, nickel, and platinum, however, will stay strong in all major end-use industries such as the automotive industry and the containers and packaging industry. A very strong demand for military aircraft and a steady recovery of the commercial airlines industry are expected to increase demand for titanium. Given a bullish recovery in investment for new plant and equipment for the chemical and petroleum processing and the energy-generating industries, demand for nickel is expected to increase. Other sources of demand for nickel include pollution abatement and waste treatment machinery for the mineral processing and the pulp and paper industries, aerospace components, gas turbines, electrical power generating and distribution equipment, and nickel-bearing alloy steels used in large tonnage earthmoving and bulk mining machinery.

The outlook for the platinum-group metals industry is encouraging because of the United States' strategic stockpile purchase program and continuing improvement in the economy. Moreover, the platinum-group metals are generally either the only materials that can be used in certain applications or are the most cost-effective metals available.

Given the above scenario, production of nonferrous metals is expected to grow at an annual rate of 5.1 percent over the 1983-89 period. Likewise, the ferrous metals industry, which includes iron and steel, is expected to follow the upward long-term trend for similar reasons. Thus, all primary metals will grow at a compound annual rate of 5.8 percent over the forecast period. Compared with the 3.9 percent rate of decline during the historical period, the forecast growth seems almost spectacular.

### Construction-Related Industries

As mentioned earlier, the medium-growth group includes both the durables and nondurables manufacturing industries. Of the nine industries included in this group, four industries (lumber and wood products; furniture and fixtures; stone, clay and glass; and fabricated metal products) are construction-related. Led by the boom in housing, the recovery has spread to all of these industries. The growth of these construction-related industries is expected to continue at 3.5 to 5.3 percent per annum, depending on the industry, over the forecast period. However, a significant increase in interest rates may retard growth in these credit-sensitive industries.

### Chemicals and Products

The chemical and products industry is the fastest-growing industry in the medium-growth group. The growth range of major industries in this segment varies from 3.8 to 7.8 percent annually over the 1983-89 period. The prospects for the petrochemical and the industrial organic chemicals industries depend on the growth of user industries, such as plastics, synthetic fibers, synthetic rubbers, and a multitude of other products. Since all these user industries fall into the high-growth group, the petrochemical and the industrial organic chemicals industries are expected to grow faster than the chemicals and chemical products segment as a whole. Moreover, there are continuing possibilities for substitution of these products for other materials, so these industries are projected to grow faster than industrial output overall.

The agricultural chemicals industry includes fertilizers and pesticides. The demand for fertilizers is derived from the demand for food and fiber which, in turn, depends on population growth. Increasing world population will increase the demand for fertilizers. However, the demand for pesticides is expected to grow faster than that of fertilizers.

The drug industry is one of only two industries (the other is fixtures and office furniture) that is expected to grow at a lower rate (4.9 percent annually) than its historical growth rate of 5.1 percent. The reason for this lower growth rate is given concisely by a National Academy of Engineering report which says that the United States pharmaceutical industry is losing its world leadership role because it has fewer new drugs under development.

The remaining industries and industry sub-groups are divided under "consumer discretionary" and "other major market segments" headings and are analyzed in that order.

### Consumer-discretionary — Durables and Nondurables

The consumer discretionary segment consists of household appliances, T.V. and radio sets, consumer instrument products, textile mill products, apparel and apparel products, printing and publishing, and paper and paper products. All but two of these sub-groups, television and radio sets and consumer instrument products, are projected to grow less rapidly than total industrial production. Even then the projected growth rates seem surprisingly high when compared with the actual growth rates for the historical period (see the table). Since most of these industry sub-groups experienced very dismal prior-period performance, even modest improvements appear to be significant in terms of percentages.

The growth of the consumer discretionary segment is closely related to the interest rate environment. High interest rates adversely affect the real estate and home-building industries which, in turn, influence industries producing products such as household appliances, consumer instrument products, and others. Therefore, given continuing improvement in the general economy, these industry sub-groups are expected to grow over the 1983-89 period.

### Other Major Market Segments

The only major industry segments left to be discussed are food and food products, mining, utilities, and petroleum products. All are projected to register growth rates that fall below that anticipated for the economy. The food and food products industry is anticipated to grow at almost the same rate as that of the historical period (2.8 percent vs. 2.6 percent). Major determinants of food consumption and expenditures are population and income. Population is expected to grow by less than one percent per annum. Therefore, its contribution toward the growth of the food industry will not be significant. Increasing incomes will increase consumption of specialty and exotic foods only. Therefore, growth trends in all foods as a group will remain relatively stable.

Given the surpluses in the oil market and relatively stable oil prices, no substantial field activities in oil and natural gas are anticipated. Even though the economic recovery will increase energy use, most of the needs will be met by the existing, under-utilized facilities. Thus, no dramatic increase in oil and natural gas extraction is expected. However, any disruption in the flow of oil and gas from the Middle East can dramatically change these expectations. Similar reasoning is applicable to the petroleum refining industry.

## REAL OUTPUT AND EMPLOYMENT

In the previous section, the projected 1983-89 growth in real output by key industries and their sub-groups was discussed. However, it is also interesting to compare these industries in terms of the employment opportunities they are expected to offer. Since durable manufacturing industries are, in general, the high

growth industries, they, as a group, are expected to provide most of the employment opportunities. The greatest growth in employment will be in the non-electrical machinery industry (4.5 percent annually) followed by the primary metal industry (3.1 percent); furniture and fixtures (2.9 percent); fabricated metal products (2.5 percent); rubber and plastic products (2.5 percent); stone, clay, and glass (2.4 percent); and instruments (2.2 percent). All other industries generate less than 2 percent annual growth in employment. However, two industries, food and food products and leather and leather products, are expected to register declines in employment.

It is interesting to note that even though manufacturing industry output is expected to grow at a compound annual rate of 5.2 percent, employment will grow at only 1.9 percent a year. The corresponding figures for the durables manufacturing industries are 6.0 percent and 2.6 percent and for the nondurables manufacturing industries, 4.2 percent and 1.0 percent. This forecast shows clearly the trend toward automation which will allow these industries to become more competitive by improving capital efficiency and cutting labor costs.■